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Editorial

The papers in this volume were presented at a conference co-hosted by the Oesterreichische Nationalbank (OeNB) and the New York-based Reinventing Bretton Woods Committee. The conference took place in Vienna, from June 20 to 22, 2004, to commemorate the 60th anniversary of the Bretton Woods institutions – the International Monetary Fund (IMF) and the World Bank and to look ahead into the governance of the international financial system.

At the conference, speakers delineated the evolution of the international financial system, outlined future challenges and formulated possible solutions to crisis situations. Core issues included the governance of the international financial system, the development and future role of exchange rate regimes and the crisis prevention and resolution toolkit.

In his introductory remarks, *Klaus Liebscher*, governor of the OeNB, stressed the fundamental role the Bretton Woods institutions, i.e. the IMF and the World Bank, play in maintaining the stability of the international financial system and in ensuring welfare and the stability of the global economy. As platforms for international cooperation, the Bretton Woods institutions fulfill an important function especially for smaller countries like Austria, which may use these forums to actively participate in international rule-making and crisis prevention and resolution processes.

As *Marc Uzan*, executive director of the Reinventing Bretton Woods Committee, pointed out, the international financial system has changed considerably since 1944 in the fields of exchange rate regimes and the number of actors in the system. Particularly since the financial crises of the 1990s, the debate over how to improve the international financial architecture and how to strengthen the international financial system has intensified. According to Mr. Uzan, integrating the emerging markets into the global economy poses much greater policy challenges than previously anticipated.

Panel 1: The Governance of the International Financial System

The keynote speaker of this panel, *Jeffrey Shafer* (Citigroup), discussed the far-reaching changes the Bretton Woods system has experienced over the last 60 years: fixed exchange rates have been replaced by floating exchange rates, capital controls have been removed to allow free cross-border capital flows and, last but not least, the euro has been introduced. Although requirements for the governance of the international financial system may have changed, the IMF and the World Bank still constitute its core institutions. According to Mr. Shafer, major challenges comprise adjusting current account imbalances, improving financial sector surveillance. For the World Bank he advocated providing grants rather than loans. In addition to that, ways of dealing with countries whose debt levels have become unsustainable must be found. Concerning IMF governance, Mr. Shafer noted that the Executive Board of the IMF is no longer representative of the present geopolitical realities, with the EU, in particular, being overrepresented and Asia being underrepresented.

Kurt Bayer (Austria), executive director of the World Bank, gave an overview of the tasks of the World Bank, whose original mission was to reduce poverty and promote development. In Mr. Bayer's opinion, the World Bank, together with regional development banks and their specialized institutions, still has the potential to contribute immensely to fulfilling this mission. Recently, strengthening the financial systems in developing and emerging economies has become even more important, particularly when bearing in mind that the damage caused by financial crises in these countries during the last few decades equals the amount of official development assistance they received.

Kemal Derviş, former Turkish minister of economic affairs, discussed the two fundamentalisms that characterized the 20th century – central planning and market fundamentalism – pointing to the fact that central planning has been discredited because of the collapse of communism. According to Mr. Derviş, the market, when left on its own, is not able to distribute all resources efficiently, but depends on government support in fulfilling this task. State and market are thus complementary actors. Markets must be embedded in adequate framework conditions. Currently, this embedding exists at the national level, but not at the international level. In Mr. Derviş' opinion the IMF has a key responsibility to correct market failures at the international level and to provide public goods like financial stability. Its two main functions are crisis resolution and the economic surveillance of member states.

Harold James, professor at Princeton University, pointed to the success of the Bretton Woods system, which had originally been based on three pillars: the IMF, the World Bank and an international trade organization, which was effectively established only in 1995, when the World Trade Organization (WTO) was founded. Mr. James explained that there has been an opposite development in the monetary domain and in trade. While the monetary order is moving away from strict rules, i.e. from a fixed exchange rate regime to a system of floating rates, trade is experiencing a shift towards more rules and regulations, as established by the WTO. Historically, exchange rate adjustments served to solve trade problems, as was the case in the U.S.A. in 1971 and 1985. Applying this kind of solution will become increasingly difficult, as half the world, i.e. the U.S.A. and Asia, have entered into an informal Bretton Woods system, in which currencies are pegged to the U.S. dollar.

Panel II: Exchange Rate Regimes

Michael Bordo, professor at Rutgers University, offered a historical account of the evolution of exchange rate regimes. Mr. Bordo emphasized the credibility of economic policy as a key factor when countries choose an exchange rate regime. While countries traditionally pegged their exchange rates to other currencies and used them as nominal anchors, the new consensus increasingly tends toward domestic monetary anchors, mostly through inflation targeting. Emerging economies with fixed exchange rates are prone to encounter difficulties. The historical performance shows that pegs work well for developing countries but not for advanced economies. The more advanced an economy is, the sooner it can switch to floating exchange rates.

Based on the European experience, *Josef Christl*, executive director of the OeNB, analyzed whether currency unions might be an option for other regions, such as Latin America or Asia. Concerning the costs and benefits of the European Economic and Monetary Union, he stated that the success and sustainability of a monetary union depend not only on a strong political will and on enforceable fiscal rules. Asia and Latin America may have taken the first steps of a Balassa sequencing by establishing free trade areas and customs unions; however, Mr. Christl said that he was not yet convinced that these regions could currently benefit from a monetary union given their varying degrees of economic development and lack of political will. He considers the adoption of inflation targeting a feasible monetary policy option for achieving macroeconomic stability and economic convergence. In concluding, Mr. Christl said that the EU experience with economic and monetary integration cannot serve as a blueprint for other regions.

Masahiro Kawai, professor at the University of Tokyo, gave a presentation on how East Asia could contribute to a stable currency system. According to Mr. Kawai, the Asian crisis has shown that regional financial architectures are needed to complement the international financial architecture. In Asia, the regional architecture currently essentially involves the Chiang Mai Initiative, the ASEAN+3 dialogue and the Asian Bond Market Initiative. Deepening regional integration and macroeconomic interdependence throughout Asia require financial stability at the regional level. It is this regional financial stability that Asia needs to be able to play a role in international economic relations commensurate with its economic power. However, the fear of losing national sovereignty, the heterogeneity of the Asian economies and the peg to the U.S. dollar render closer cooperation difficult.

Panel III: Crisis Prevention and Resolution

Pedro Malan, former finance minister of Brazil, emphasized how sharply circumstances have changed since the creation of the Bretton Woods system. In Mr. Malan's opinion there is a broad consensus that sustainable macroeconomic policies and stable – rather than fragile – financial systems are needed, while institutional weaknesses have to be eliminated. Addressing economic problems in individual countries is a key priority, but a number of international issues have to be solved as well. One such issue is the asymmetric distribution of information between borrowers and lenders. A surge in debt after the first oil price shock and a rise in interest rates originating in the U.S.A. had triggered the debt crisis of the 1980s, which was not overcome until the Brady Plan was introduced in 1989. In Mr. Malan's opinion, the Sovereign Debt Restructuring Mechanism (SDRM) the IMF proposed is not an adequate means for resolving crises in emerging economies, in particular in his home country Brazil. Instead, he advocated a wider use of Collective Action Clauses (CACs) and stated that close cooperation between the public and private sectors and international institutions is essential.

Gertrude Tumpel-Gugerell, member of the Executive Board of the European Central Bank, analyzed the international crisis prevention toolkit. She particularly underlined the aspect of transparency, pointing out that greater transparency should make it easier for market participants to assess risks. Ms. Tumpel-Gugerell stressed the IMF's increased efforts to promote the provision of data through the Special Data Dissemination Standard. She also emphasized that the Bretton Woods institutions have stepped up their efforts to achieve financial stability, e.g. by establishing an International Capital Markets Department and by drawing up the Financial Sector Assessment Programs (FSAPs). In addition, the IMF's balance sheet approach ensures that countries' balance sheets are monitored more closely in order to detect mismatches that may affect their debt-servicing abilities. Ms. Tumpel-Gugerell continued by saying that views were still evolving on the appropriate balance between transparency and confidentiality. In her opinion, the question whether all the efforts mentioned have actually improved crisis resilience remains an open issue.

Anne O. Krueger, first deputy managing director of the IMF, said that the IMF's mission – to provide a stable international financial system as a sound basis for promoting trade expansion and economic growth – has remained valid since its foundation in 1944, but that the methods used to achieve this mission have changed. Demands on the IMF have also altered, particularly since the capital account crises of the 1990s. Among other issues, Ms. Krueger focused on the pronounced changes in the IMF's surveillance function and on its crisis resolution toolkit. She quoted the enhanced transparency in the dialogue between the IMF, its members and the broader public, the movement away from fixed exchange rates and an expanded definition of macroeconomic stability among the major changes in the Fund's surveillance work. Ms. Krueger underlined the importance of CACs in crisis resolution, even though, in her opinion, it is still much too soon to evaluate to what extent CACs can improve the orderly resolution of sovereign debt crises. By way of conclusion, she said that the IMF, just like the world economy, is constantly evolving and that the Fund should, where possible, try to remain at the cutting edge of global economic developments.

Christian Just
Franz Nauschnigg

The Importance of the Bretton Woods Institutions for Small Countries Opening Address

Klaus Liebscher

Governor, Oesterreichische Nationalbank

Ladies and Gentlemen,

It is with great pleasure that I may welcome you to the conference on "60 Years of Bretton Woods – Governance of the International Financial System – Looking Ahead" hosted by the Oesterreichische Nationalbank. I am equally delighted that we managed to attract so many distinguished speakers from around the globe, who are here in Vienna today to discuss various aspects of the governance of the international financial system with us. I would like to express my sincerest gratitude to all these speakers for their contributions in advance. I feel also honored that such a great number of you have accepted our invitation to participate in what promises to be an ideal opportunity to reflect upon the history and future of the Bretton Woods Institutions.

During our conference it is supposed that policymakers, investment bankers and academics will discuss the governance of the international financial system, debate about exchange rate issues and explore ways to improve the current crisis prevention and resolution framework. We believe that these three broad themes are central to the debate on the international financial architecture.

1. A Brief Review of 60 Years of Bretton Woods

The 1930s demonstrated that the pursuit of nationalistic beggar-thy-neighbor policies can have dramatic and devastating effects.

In order to prevent a repetition of this destructive experience, the Bretton Woods system consisting of the International Monetary Fund (IMF) and the World Bank was created in 1944 to govern the post World War II economic system. This regime was expected to perform three important functions:

- a regulatory function by administering the rules governing currency values and convertibility,
- a financial function via the supply of supplementary liquidity to members facing balance of payment pressures and
- a consultative function by providing a forum for cooperation among governments.

I consider the Bretton Woods system very innovative for four reasons: First, with this system international monetary cooperation was for the first time attempted on a permanent and institutional basis. Second, this system respects the principle of national sovereignty while committing members to collective responsibility. Third, it provides a mechanism for inter-governmental consultation. And fourth, even though the principle of national sovereignty is respected, voting rights are allocated in proportion to quotas rather than on a one-state, one-vote basis.

The first major systemic crisis – the breakdown of both the gold exchange standard and the par value system of the original Bretton Woods system in the early 1970s – was weathered surprisingly well. Unlike during the 1930s, monetary relations did not degenerate into total chaos. Instead, a significant degree of cooperation was preserved under the auspices of the IMF.

Later on the international financial system has been exposed to a string of crises since the early 1980s. But the IMF in particular was chastised for its role in the crises of the mid- and late 1990s. A common feature of these crises was that they grew out of weaknesses in domestic economic policy frameworks accentuated by international capital flows and often in combination with unsustainable fixed exchange rate pegs. In most of these cases, Fund surveillance had not ex ante and publicly stressed the weakness of domestic or financial sector frameworks or questioned the inconsistence of economic policies with a fixed peg.

The social impact of crises on countries raised questions about the IMF's approach, its quality of advice and accountability. Academics, policymakers and nongovernmental organizations alike criticized the IMF for advocating rapid capital account liberalization and paying insufficient attention to the foundations for stability and growth; for applying a “one-size-fits-all” model that was insensitive to countries' individual circumstances and needs; for advocating policies that served primarily the interests of creditors and for being insufficiently open to outside views and advice.

While some of this criticism seems justified, I do not wish to ponder the counterfactual: what if the IMF had not existed and thus would not have helped resolve these crises? In addition, the Independent Evaluation Office of the IMF, having reviewed some of the aforementioned criticism, refuted most of it.

In other areas, the Fund reacted to the criticism and has changed some of its policies, for instance with respect to capital account liberalization. To my mind, these are very important developments which show that the Bretton Woods

Institutions are – without any doubt – learning institutions. What is more, these institutions are of significant importance when we look for an orderly solution to economic imbalances or financial crises.

2. Multilateralism and Governance of the International Financial System

The main function of international financial institutions today is to provide the best framework for the governance of globalization so that this process becomes a win-win proposition, in which all economies ultimately benefit through productivity and growth effects.

This means that a level playing field should exist that governs the integration of national economies via trade in goods and services in particular to minimize unfair cross-border competition. A world of global capital markets offers faster rewards for success both for the countries concerned and for the international system; on the other hand, weaknesses are also punished harder and faster than before. Globalization presents all economies with new opportunities.

More substantial trade and investment flows lead to lower prices and greater choice, larger markets and economies of scale and faster adoption of new technologies. Stiffer competition among firms and exposure to the world's best-practice standards as well as free movement of capital generate a more efficient allocation of resources. Thus, globalization can play a major role in enhancing growth and living standards.

However, there are risks associated with globalization and liberalization that need to be properly managed by policymakers. Globalization entails not only new opportunities but possibly also new inequalities that need to be anticipated and addressed both in developed and developing countries. As a case in point, the recent financial instability demonstrates the risks associated with volatile global capital markets. Fully opening up to liberalization too early and too quickly, without the necessary preparations, is dangerous. Countries must first put in place appropriate policies and institutional frameworks. The IMF's surveillance mandate is just the instrument to achieve this aim.

3. Surveillance and Crisis Prevention

Self-surveillance is the most effective form of surveillance since self-interest should motivate countries to pursue stronger policies. The ultimate reward for countries with improved policies will be higher economic growth and a higher standard of living for their citizens.

The effectiveness of external surveillance – like the IMF's surveillance mandate – is very much dependent on the credibility of the review process. International organizations can add weight to local voices: national think tanks or academics might have said something many times over and, yet, it helps to have a credible body such as the IMF says it, too.

Therefore, international organizations must ensure that the analysis and advice presented to countries is not perceived either to be tainted by special interests or weakened by the use of flawed analytical methods.

As to its surveillance mandate, the IMF faces critical limitations. In seeking to provide good advice, the IMF is constrained for example by a country's economic progress and authorities' willingness to follow up on advice. However, based on experience across many countries, a consensus has emerged about the broad guidelines for policies that serve the goal of sustained growth and thus should help in preventing crisis. These policies include, among other factors, the need to support an appropriate macroeconomic and microeconomic environment, the need for a market-oriented system with a high level of competition, openness to international trade and investment, price stability and exchange rates that broadly reflect international competitiveness.

All of this has led to a shift in the crisis prevention strategy employed by the IMF. The IMF now concentrates on identifying vulnerabilities, such as excessive sovereign debt or balance sheet mismatches. Also, its stance on capital account liberalization has changed. Today, the IMF advocates that member countries should first have the institutional capacity and a relatively strong financial sector with a sound supervision regime before taking this major step. In fact, before fully liberalizing all capital movements in 1991, Austria had followed this policy. Back then, Austria was criticized for this policy which has now become conventional IMF wisdom.

One important initiative in the sphere of crisis prevention is the Financial Sector Assessment Programs (FSAP), which are conducted together with the World Bank. An FSAP is designed to establish a profile of the strengths and weaknesses of the financial sector of a given country. This initiative is not only geared towards emerging market countries (EMCs) or developing countries, but also towards industrial countries. Austria, for example, just conducted an FSAP with excellent results.

Another important area constitutes economic and financial standards and codes, which are formulated in collaboration with public and private sector institutions. Their aim is to promote meaningful comparable statistics, transparency rules for fiscal and monetary policies and supervisory standards for the banking, securities and insurance sectors. This is meant to facilitate the integration of countries into the global economy.

Will all of these initiatives prevent financial crises altogether? Overshooting and correction will always be part of financial markets. This means that in an open and dynamic market economy there are limits to our capacity to anticipate and prevent crises.

However, with skillful and prudent economic, monetary and financial policies, crises should occur less often and they should be less severe.

4. Crisis Management and Resolution

Over the last 20 years, the Bretton Woods Institutions had to deal with a continuous series of financial incidents. These crises encompassed economic misalignments and systemic vulnerabilities, such as evinced in the Mexican or East Asian financial crises and financial disruptions due to contagion across countries and markets, as for example during the Russian debt default of 1998.

The success of the Bretton Woods Institutions should be reflected in a declining trend of the overall number of Fund-supported programs over time. There are legitimate cases which require access to Fund resources. However, the Fund's financing role should and can only be catalytic, given its limited resources. While policies, such as the exceptional access framework, are in place to safeguard Fund resources, they are often not adhered to.

I am also concerned about the prolonged use of Fund resources which is out of line with its mandate. Countries that run IMF-supported programs over many years or decades are probably not a demonstration of success. Thus, the IMF should strive to prevent that countries become dependent on IMF financing.

During the debt crises of the early 1980s, the IMF acted more as a crisis manager or the official agent in charge of concerted bank lending. This role has shifted over the years, with the Fund now practically resolving countries' financial crises on its own. An important initiative to reposition the Fund once again as a crisis manager came to be known as the private sector involvement (PSI) initiative. PSI encapsulates the official sector's attempt to engage the private sector in crisis resolution more effectively. The private sector has to assume responsibility for its investment decisions. This is grounded in my firm conviction that a collectivization of private sector losses would distort the allocative efficiency of capital markets and would lead to moral hazard via increased risk-taking.

Another important initiative, which the IMF started to discuss in late 2001, proposed to establish an international bankruptcy procedure for unsustainable sovereign debt (SDRM). I believe that this mechanism would have made the PSI initiative more operational. However, the time may not have been ripe yet for such a comprehensive framework for the restructuring of sovereign debt. Nevertheless, public and academic awareness has been raised.

The debate has helped in that many EMCs have introduced collective action clauses (CACs) in their sovereign bond contracts and major EMCs and the private sector are discussing a Code of Conduct. This notwithstanding, I am firmly convinced that we need an international arrangement which would facilitate the orderly resolution of sovereign debt crises.

Such an arrangement would also help shift the function of the IMF from its current role as crisis solver to crisis manager.

5. Economies in Transition, Developing Countries and Poverty Reduction

In addition to finding more effective mechanisms for crisis prevention and management, the international community faces another major challenge, the eradication of poverty.

One of our prerogatives should be to integrate developing and transition economies in such a way that they can maximize the benefits of globalization, while minimizing the costs.

This implies, specifically, helping these countries attract sufficient sustained private capital flows, while strengthening measures for crisis prevention and better crisis management, supporting policies and structural reforms that facilitate development, and helping secure sufficient external funding to sustain their growth and poverty reduction.

While not being a “development” institution in spirit and by design, the Fund’s role in the developing countries has nevertheless become an essential and integral part of the efforts of the whole international community to advance development.

Especially by launching the HIPC (Highly Indebted Poor Countries), the PRSP (Poverty Reduction and Strategy Papers) and the PRGF (Poverty Reduction and Growth Facility) initiatives, the Fund substantially reframed its role in low-income countries, making poverty reduction and growth the key objectives and modalities for programs supported by the Fund. While the PRGF relates strictly to the Fund’s role, the HIPC and the PRSP initiatives guide the cooperation with developing countries, the Fund, and also the World Bank.

I see the Fund’s role in developing countries and especially its financing role as catalytic rather than substantial. The Fund should allocate only a limited amount of financial aid to developing countries in support of their progress towards macroeconomic stability and financial soundness.

Turning to transition economies, I believe that we often overlook the strong track record both the IMF and the World Bank have established in these countries.

While the Bretton Woods Institutions were caught as much by surprise by the collapse of Communism as everybody else, their involvement in these countries was instrumental to their integration into the world economy. At the beginning of the 1990s, the majority of transition economies had some form of IMF involvement via a fully-fledged IMF program or technical assistance. The IMF together with the World Bank worked hard to stabilize the economies of these countries, devise economic policies and build modern institutions, thus transforming many of these economies into today’s very successful market economies.

Owing to a common history and its geographic location, Austria has a particular interest in the stability and economic progress of the transition economies.

Austria had already started in the late 1980s to develop extensive economic ties with the transition economies, which have increased substantially over time.

Strong trade linkages, very high levels of foreign direct investment and support for their integration into either the EU or other international institutions have been mainstays of Austria's policies towards the transition economies. In addition, in 1992, Austria decided to participate in setting up the Joint Vienna Institute together with the IMF and other international organizations to respond to the strong demand from economies in transition to train officials in market economics and the free enterprise system.

6. Conclusion

Ladies and Gentlemen!
Austria joined the World Bank/IBRD in 1948 and the IMF in 1952 and has been an active and supportive member of the Bretton Woods Institutions (BWI) ever since. Especially for a small open economy like Austria, the BWI were and still are important windows to the rest of the world. Therefore, both the Oesterreichische Nationalbank as well as the Ministry of Finance have always kept close and good working relationships with the management and staff of the IFIs.

I am a firm believer in the value of the Bretton Woods Institutions for the global economy as a whole as well as for small countries and the positive contribution they have made to the world economy. The 60th anniversary, this conference or the strategic review of International Financial Institutions which is presently conducted by the G 7 mark an opportunity to look afresh at these institutions, assess whether they have fulfilled their respective mandates and reflect upon their future roles. However, I expect that we will not attempt to overhaul the system which can be improved upon but ultimately has worked to the benefit of all.

I sincerely hope and advocate that we go back to the roots of these institutions with the World Bank as the primary institution for structural policies and development and the IMF as the institution for short-term macroeconomic surveillance, crisis prevention and crisis management rather than attempt to redefine their respective roles. In addition, what sometimes is forgotten in many reform debates: these institutions fulfill functions for all their members and cannot or should not be narrowed.

In concluding, I am looking forward to fruitful and challenging discussions during our conference and I wish all of you an interesting stay here in Vienna.

Reinventing Bretton Woods?

Marc Uzan

Executive Director
The Reinventing Bretton Woods Committee, U.S.A.

Is the notion of Reinventing Bretton Woods conceivable? This simple question brings a multitude of thoughts about the bold objectives of the 45 nations whose representatives gathered at Bretton Woods, New Hampshire in the summer of 1944 to establish a new economic order; about the extent to which these ambitions have been fulfilled; about the many new challenges that have arisen in the world economy since Bretton Woods; and where, in view of these challenges, the international financial system is leading us. It is certainly true that the international monetary system has changed considerably since Bretton Woods – and in ways that were largely unforeseen in 1944. Instead of a system of fixed exchange rates among major currencies, we now have a floating rate system. Where capital controls were once pervasive, we now have global financial markets. From the relatively small group of 35 countries that became the founding members of the International Monetary Fund (IMF), Fund membership has expanded to include virtually every economy in the world. Indeed, all the complexities and uncertainties that the existing international monetary system presents, Bretton Woods seems to evoke a more orderly and cohesive world, raising the question of whether the international community should not strive toward a *new* Bretton Woods.

In order to answer this question, however, one must first consider more fully what Bretton Woods and the IMF, the institution established to oversee the new monetary order, were intended to achieve. Bretton Woods has become almost synonymous with the fixed exchange rate system that prevailed from the time of the IMF's establishment until the abandonment of fixed rates in 1973. However, the visionaries at the Bretton Woods conference had broader objectives in mind. As stated in the IMF's Articles of Agreement[1], they were striving toward a system that would “promote international monetary cooperation,” “facilitate the expansion and balanced growth of international trade,” and “contribute thereby to the promotion and maintenance of high levels of employment and real income....” They also aimed to “promote exchange stability...maintain orderly exchange arrangements

[1] Adopted at the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, July 22, 1944.

among members and...avoid competitive exchange depreciation." At the same time, they wanted to "assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade." As these goals suggest, the purpose of *Bretton Woods* was above all to establish a more stable and prosperous world economy, and the role of the IMF, to help promote the preconditions for this. The IMF carries out this role by exercising *firm surveillance*.

In considering whether a *new* Bretton Woods is conceivable – or indeed desirable – I would like to evaluate more specifically in my presentation what we learned from the 1990s with the international financial architecture debate.

The last decade has seen a string of crises in emerging markets: Mexico in 1995, Asia in 1997 and 1998, Russia in 1998, Brazil in 1998 and 2002, Argentina in 2001-02, and Turkey in 1999 and 2000-01. The turbulence and its contagion, in financial markets have prompted a wide range of efforts in the 1990s to improve the international financial system, including statements of the G-7 industrial nations. As policymakers, market participants, and academics around the world debated the next steps to address weaknesses in the system, they face a number of critical questions.

The world financial crisis demonstrates that the integration of emerging economies into the global financial system poses much larger policy challenges than had previously been anticipated. The early 1990s will be remembered in the degree of euphoria that had emerged about the benefits of financial liberalization, private capital flows and emerging markets. Now, that the risks and the costs have become more evident, a stronger foundation that would support these benefits with less risk may yet emerge.

Fears that capitalism had run amok and globalization would lead to poverty for most of the world galvanized Western leaders into promising swift reforms of the so-called *international financial architecture*. The Mexican crisis led to the first global debate about the market-led international financial system in which governments are at the mercy of huge flows of private capital that spill across borders, playing havoc with currencies.

The debate took another dimension with the Asian crises, which engulfed Thailand, Indonesia and Korea and then spilled over into Russia, New York financial markets and Brazil – initially centered on who was to blame and what went wrong. Fingers were pointed at unscrupulous speculators, irresponsible bankers and cronyism.

But a plethora of proposals to scrap the existing framework and replace it with a *new* international financial architecture was sidelined by promises of *reform* of the international financial architecture.

The idea was to strengthen rather than tear down and rebuild the skeleton holding together the international financial system, which has no true global authority to enforce rules on sovereign governments. The phrase "reform of the international financial architecture" has been bandied about for years now, topping the agendas of international summits and countless meetings by institutions and policy-making bodies. Two years of debate to explore the possibility of a sovereign debt restructuring mechanism, the international community has decided at this stage to pursue a more market-driven approach through the use of collective action clauses in bond documentation and possibly a code of good conduct clarifying the principles and responsibilities of issuers and creditors in the context of a debt restructuring. Nevertheless, the debate is not over, and the Argentina restructuring is likely to have significant ramifications.

From 1994 to 2004:

In September 1994, when the international financial community met in Madrid to celebrate the 50th anniversary of the Bretton Woods institutions, few observers will have predicted that the period will be followed by a series of financial crises and that the notion of capital flows, moral hazard, bail outs, collective action clauses, debt sustainability, standards and codes, will be the key words of the 1990s.

Today, when we are today celebrating the 60th anniversary of the Bretton Woods conference, I would like to outline some key trends that will affect the role of the IMF.

1. Exchange Rate System

The Asian and Argentine crises as well as the Dubai G-7 communiqué have strengthened a movement within the international financial community to emphasize flexibility in exchange rate systems. Yet, many important countries continue to effectively peg their rates. What is an appropriate path toward flexibility for emerging market economies? How can the system as a whole improve its contribution to the adjustment of major, sustained balance of payment imbalances? Now that the euro has become more established and Japan's economy may finally be returning to health, are we likely to see countries diversify their reserves away from dollar assets? What would be the implications of a world of multiple reserve currencies?

Today, there is little doubt that China's exchange rate policy has emerged as a major global topic. China is perceived as a threat because it has been enjoying export growth of 35% during recent months. As a result of booming foreign direct investment and the return of flight capital, China also has foreign exchange reserves of USD 355 billion or the second highest in the world after Japan. The U.S.A. is now able to finance its large fiscal deficits and current account deficits because of currency intervention by Asian central banks, especially Japan and China. The central banks of China and Hong Kong have purchased nearly USD 100 billion of U.S. government securities during the past eighteen months. The

East Asian central banks now have 70% of the world's foreign exchange reserves compared to only 30% in 1990 and 21% in 1970. They keep their USD 1.7 trillion of reserves 80-90% invested in U.S. government securities.

On the eve of the 60th anniversary of the creation of the Bretton Woods system, some observers have argued that we may be re-entering *the old paradigm*. Professor Michael Dooley and his colleagues argue in a recent paper that the system was never actually destroyed just put into hibernation. Just as Europe and Japan benefited from fixed exchange rates in the 1950s and 1960s, the reasoning goes, so Asia is now profiting from the same. The success of China and India in exporting goods and services respectively is certainly built in part on undervalued currencies. Some Asian currencies are fixed, some have a managed float, but all of them are accumulating vast amounts of official reserves in U.S. dollars. The insight of Dooley's team is that this is an explicit contract, like Bretton Woods, not the operation of a free market. China has the potential to be a source of strength as well as vulnerability in reinforcing the precarious stability that has now returned to the international financial system, and in forwarding the recently interrupted move toward a genuinely global system of open finance. How it manages its multiple transformations will be of enormous importance for the international monetary system.

2. The Future Role of the International Monetary Fund

Many of the discussions on a new international financial architecture that were spawned by the Mexican crisis and continued through the Argentinean crisis raised questions about the future role of the IMF. Four major areas merit attention: 1) the scope of Fund activities, 2) surveillance, 3) lending, and 4) governance. The IMF is still needed to help countries resolve payments problems in an internationally responsible way, to address liquidity crises, and to act as a crisis manager or convenor. Does this mean that crisis prevention should be at the core of the IMF's work? Should it deepen its efforts to collect and disseminate information to investors and markets, further covering indicators of financial vulnerability as well as macroeconomic fundamentals? To what extent should its resources be expanded to enable it to provide liquidity, and under what circumstances should the Fund provide backstop financing for countries?

According to observers, the large financing packages of recent years have increased the fund's financial risks.

Credit outstanding the largest three borrowers have reached an unprecedented share of total fund credit. This increased concentration in Fund exposure has been associated with a prolonged use of Fund resources by middle income countries with access to international capital markets. The current level of concentration has some precedent. But the importance difference is that previous episodes of high concentration reflected current account deficits of few large members which were offset by the current account surpluses of other members. What do these trends mean for the IMF and for the shareholders? And in relation, what is the likely future evolution of the demand for Fund resources? For example, the financial support provided by the IMF program with Mexico amounted to 18 billion U.S. dollars. This sum represented 6.3% of Mexico's GDP. If China achieves levels of per capita income similar to Mexico and becomes vulnerable to capital account crises, the potential for demand for fund resources relative to future GDP could become very large That suggests that the cost of mitigating an emerging market style crisis in a country like China or India could well be of an order of magnitude that would dwarf present day level of fund resources. But other economic developments may temper this tendency as developing countries have increased their international reserves for self insurance and we are seeing a shift towards more flexible exchange rate regime that might temper the need of future demand for Fund resources.

Indeed, the environment in which the Fund operates has changed but the instruments at the Funds disposal have not. Can the IMF perform within its current governance structure or does it require a change in the governance reform? Does the Fund have the internal governance and risk control mechanism to deal with capital account crises?(If the preferred credit status should be reexamined in this new evolution, if we deal with fiscal policies difficulties and not balance of payment problems.)

How can disparities in economic weight and financial contributions be reconciled with the need for more inclusive decision-making in international institutions and arrangements (for example, in IMF voting)? Should the G-7 be expanded, perhaps through the inclusion of China? More broadly, how can emerging economies be best represented in the international financial architecture, recognizing that improving their development prospects is a principal aim of global financial governance? Will the G-20 serve as a basis, perhaps in combination with regional forms of governance? With the advent of the euro, should we now consider one EU single seat at the IMF?

These reflections bring me back to the question of *Reinventing Bretton Woods*. Despite the considerable changes that have occurred in the international economy since the Bretton Woods conference, I believe that the Bretton Woods goals are as valid today as they were half a century ago. In this respect, to the extent that a *new* Bretton Woods is needed, it would be necessary to re-establish the strong sense of purpose and determination that motivated the founders of the Bretton Woods system, based on a machinery of international cooperation.

If we decide to meet again in ten years, we will be facing an international financial architecture very different from the one that we have today.

Governance of the International Financial System: Objectives, Issues and Process

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Sixty years after the Bretton Woods Conference, much has changed.

- The European colonial empires have been dismantled, greatly expanding the number of nation-states.
- The development of the European Union of twenty-five tightly linked nations, twelve of which use a common currency, with the prospect of still more broadening and deepening ahead, has introduced a fundamentally new structure into the global political economy.

The division of the world into two economic ideologies has been bridged.

- The world of fixed exchange rates that was envisioned at Bretton Woods has been replaced by one where floating exchange rates are considered the norm.
- The extensive capital controls that were foreseen at Bretton Woods as a permanent fixture of the financial order have been dismantled in the OECD member countries and radically scaled back, if not removed, in the emerging markets. This development together with leaps in communications technology has led to the development of global banking and capital markets with the potential for massive cross-border capital flows.

But three fundamentals of the Bretton Woods Agreements still hold today. First, the International Monetary Fund (IMF) and World Bank remain the core global institutions in the monetary and financial domain. They have adapted to change, indeed the greatest genius of their creators was to provide for change. Although these institutions have many critics, serious people do not call for their dissolution or replacement. If the Bank and Fund did not exist, we would have to invent them. And it is extremely doubtful that they would be invented today more sound than the Bank and Fund that we have. The right course for the world is to continue the process that has been working almost since their creation, a process of evolution in the light of a changing environment while complementing the two institutions with less formal and ideally less permanent structures, such as the G-7, G-10, G-20, G-24 and the Financial Stability Forum.

Second, we live still in a world where legitimacy and accountability for economic outcomes rest with sovereign states, noting some qualification for the European Union. Nations make laws, undertake social programs, raise taxes, spend on behalf of the public and choose their monetary institutions. It would be neither right nor welcome for these responsibilities to be assumed by global supranational authorities.

Third, economic and financial interdependence mean that states do not pursue their objectives independently. What one does affects others. This is true for large actors or "systemically important" countries. It is also true for aggregations of smaller countries behaving in similar ways in response to a common environment. Indeed, with increased trade and financial openness, interdependence has never been greater.

In considering how financial governance might be improved, it is important to examine three aspects: 1) the assumption that one makes about the *objectives* of governments, 2) the *issues* that it is most important to resolve at any given time and 3) the *process* by which coordination takes place among sovereign governments. I have some observations to offer on each of these, but only have concrete proposals on the third. On the matter of process, I will draw on a report, to be published in September, which I have prepared together with Peter Kenen, professor at Princeton University, Sir Nigel Wicks, former IMF and World Bank Executive Director and long-time G-7 Deputy for the United Kingdom and Charles Wyplosz, Professor and Director of the International Center for Monetary and Banking Studies at the Graduate Institute of International Studies in Geneva. Our Report, titled "International Economic and Financial Cooperation: New Issues, New Actions and New Responses" is sponsored by the International Center for Monetary and Banking Studies in Geneva and the Center for Economic Policy Research.[2] It focuses on process issues. As we say, "if we don't get the process right, we won't get the policies right." I nevertheless want to lead up to that report's principal recommendations with some observations on objectives and issues for which I will not hold my co-authors responsible.

[2] Peter B. Kenen, Jeffrey R. Shafer, Nigel L. Wicks and Charles Wyplosz (2004). International Economic and Financial Cooperation: New Issues, New Actors, New Responses. Geneva Reports on the World Economy 6. International Center for Monetary and Banking Studies and Center for Economic Policy Research.

1. Objectives of Economic and Financial Policy

The assumption on which the Bretton Woods institutions were built is that governments seek to improve the economic welfare of their populations broadly, weighing the interests of future generations as well as their current citizens. They may make mistakes that the officials of the Bank and Fund could warn them about, but governments were presumed to be well intentioned. Good governance at the national level was not explicitly questioned. This is a naively idealistic view of the world.

This presumption of good governance or the practice of ignoring seriously flawed governance has come increasingly to be questioned in recent years. Improved governance has become an objective of some World Bank programs, and governance considerations have crept into Bank and Fund programs more broadly. For example, structural conditions imposed by the IMF on borrowers during the Asian crisis were partly directed at confronting cronyism in its various forms – institutionalized family corruption in Indonesia and the power of the chaebol in South Korea. Strong criticism of these aspects of IMF programs by Jeff Sachs, Joe Stiglitz, Marty Feldstein and others has led the IMF to pull back from conditions of the sort used in the Asian crisis. But the problem of governance failures remains and will sap the effectiveness of the Bretton Woods institutions in the future if they turn a blind eye to them.

Notably, it is still considered the role of the Fund to curb one governance failure found even in vigorous democracies, where elected leaders are presumably attuned to the economic interests of voters: that is, the political business cycle. Thus, IMF fiscal conditions typically seek to impose an intertemporal budget constraint that may not be felt strongly by elected officials who may not think beyond the next election. This constraint may also not be imposed by financial markets if IMF-led support packages are available.

Governance problems are, however, much more problematic for the programs of the Fund and Bank than this. Corruption that results in the loss or diversion of the proceeds of Bank loans and leaves a country's citizens without benefits but with future debt service obligations continues to be a serious problem. Reform efforts to date have not alleviated concerns on this point. Extreme situations of institutionalized discrimination where governments systematically prevent people from disfavored ethnic groups and religions or women from full participation in economic life, or of predator states whose governments loot the resources of the people to enrich an elite, or of failed states in which governments do not effectively protect life and property may lead to disengagement by the Bretton Woods Institutions. If transferring resources to government hands is the only means of intervention, there may be no reasonable alternative. But a rigid policy of not putting resources into a high-risk environment means that the international community abandons people most in need of help. There is a dilemma here.

I do not have solutions today. But the problem of governance failure, which I take to mean that government leaders may pursue other objectives than the economic welfare of people across the entire population and over time, is serious and it is pervasive. The issue needs to be kept out in the open. And it should be addressed by a process that is seen to be representative and legitimate. The experiments with structural conditionality during the Asian crisis were criticized, in part, because they seemed to be largely the result of U.S. Treasury pressure. I believe that this is an extreme exaggeration. But there is a need to develop broad support for governance conditionality while not giving dysfunctional states the capacity to form a blocking coalition as they have been able to do, for example, in the United Nations General Assembly (UNGA). Only then can we have reasonable assurance that the objectives of the Bretton Woods institutions of furthering the economic wellbeing of a country's people broadly will be achieved.

2. Issues

The central issues concerning the international financial system have shown some continuity, but have also changed markedly over sixty years. Four issues stand out as most important today. First is the adjustment process.

Whether considering what to do in the current situation or longer-term systemic reform, the balance-of-payments adjustment process has been at the heart of much of the debate in international finance from the beginning. What should countries in different positions be expected to do, if anything, when there is evidence of a serious international disequilibrium? To start with, what is considered disequilibrium has been debated and views have changed – is it indicated by reserve inflows or outflows? A misaligned exchange rate, however measured? A current account imbalance? A fiscal imbalance? Inflation or deflation? High unemployment? Whatever the answer, the adjustment process is a matter of perennial concern because what one country does affects others. This can happen in three ways: First, some countries are so large that what they do affects the world. They are the elephants among smaller animals. The United States has been seen this way since Bretton Woods, and over the years, a large part of the debates on the adjustment process has had in the background the question: "How can the United States be made to manage its economy less disruptively for others?" Within Europe, Germany has often been seen as the heavyweight, while in Asia, Japan has been a regional elephant and China is rapidly becoming one. Second, countries heading in the same direction can have important combined external effects. Herds of smaller animals can be as disruptive as elephants. Thus, for example, the huge current account imbalance between the United States and emerging Asia is widely dispersed around Asia. The focus in the United States on China is misplaced since China has only a small external imbalance. But adding up current account surpluses over the region produces a large imbalance. The U.S. elephant could not adjust, if it were inclined to, without the Asian herd moving too or other large imbalances appearing somewhere else. Third, there may also be times when two herds move in opposite directions. In these cases, the adjustment process is asymmetrical with intense pressure on countries in deficit, but little on those in surplus.

Another externality, beyond direct effects of one economy on another, arises out of the actual or prospective use of "IMF resources" to support the adjustment process. The resources, of course, are not the Fund's, they are transferred from one member to another. Their use is a matter of concern to creditors of the IMF for this reason if for no other. In addition, the terms and conditions of the uses of Fund resources in each case set precedents, alter expectations and thus have externalities. This makes the use of Fund resources to support adjustment a matter of concern to all. The importance of the adjustment process to all: large countries and small, those in surplus and those in deficit, means that the process for considering change and implementing it, should be broadly representative.

One aspect of the adjustment process has been especially troublesome: surveillance. Despite emphasis on the need for an effective surveillance process going back at least as far as I can remember, problems frequently go unrecognized until they become critical. Moreover, when a country has no need of International Financial Institutions' (IFI) support, it can resist calls to adjust. This is true of small countries as well as large. The coming of transparency to once secret international monetary affairs may make it harder to ignore developing problems in the future since markets are watching, but I do not believe this is a cure-all. For one thing, it does not deal with the asymmetry of pressures. And another trend is disturbing: countries have been brought into chronic dependence on Fund programs, with the justification that it gives the IFIs leverage over policies. It would be much better to foster independence maintained through sound policies.

A more recent set of global financial issues involves the supervision, regulation and functioning of domestic banking systems and capital markets, and their interactions in a global financial system. Since banking authorities first confronted the unavoidable need to cooperate following the failure of Bank Herrstatt in 1974, the range of issues on which cooperation has been pursued has grown spectacularly: supervisory responsibilities, capital requirements, lender-of-last-resort responsibilities, payments systems, anti-money laundering, strengthening domestic banking systems in emerging markets, supervision of financial conglomerates whose activities cross the jurisdictions of multiple functional regulators as well as national borders, disclosure and accounting standards in global capital markets, corporate governance, privacy... A rapidly changing financial landscape has demanded a response. And there has been a strong response, with central banks leading the way. The establishment of the Financial Stability Forum has brought focus and some coherence to disparate activities. This may become the new heart of international financial cooperation going forward.

A third issue has become more important as global financial markets have become broader, deeper and more mature, but it has received only limited attention. This issue is: in a world where private capital is available, many would say too available, to any country with reasonable political stability, sound policies and not too great a debt burden from past laxity, what is the role for the World Bank? It is hard to make a case for "gap filling" today, as was done in the 1960s when channels for private capital to flow to developing countries were shallow. Capital still does not flow to the poorest countries, but this is because the rate of return is low and the risk is high in the absence of supporting institutions and human capital. This situation does not provide favorable conditions for official lending. We have learned that official capital flows often leave more costs in the form of debt burdens than benefits in development progress. IFI debts are having to be forgiven to alleviate the accumulated burdens. Recognition of the limited debt carrying capacity of the poorest countries has motivated calls for International Development Association (IDA) loans to them to be replaced by grants. This is surely what is needed. We shall see if the required resources are forthcoming.

For countries that have achieved market access, the World Bank Group (including the International Finance Corporation, (IFC)) faces the question of how it can make its lending additional and not simply crowd out private sector flows. It is not going to do this as a preferred creditor, because repayment obligations to the Bank reduce capacity to service other debt, unless it can boost debt servicing capacity by more than private sector flows do. This is an immense challenge to the Bank staff, especially when it is called upon to focus on poverty reduction. The Bank may seek to achieve additionality in terms of development impact by spreading the benefits of economic growth more widely in the population, even at some sacrifice of overall transfers. But the requirement that such efforts be highly effective in addition to being well-intended is a high hurdle. It is not often cleared. I expect that these issues will receive even greater attention in the coming years.

The issue that I have seen most often highlighted in sixtieth anniversary events is what to do with countries that clearly cannot maintain full servicing of their debts. Both middle income and the poorest countries are of concern. There are answers emerging that have a reasonable chance of proving workable.

For middle income countries, liquidity crises when debt burdens seem reasonably manageable over the longer term are likely to be less common than they were in the 1990s, since countries have seen the huge costs of losing market access even temporarily, and they maintain much higher reserves together with longer term debt structures in order to guard against such a crisis. If a crisis does occur in a country with a sustainable debt burden, large scale financing by the IMF should, and I suspect will, be forthcoming. Regional arrangements, such as the Asian swap network, may provide a second line of defense. Such rescues will not be so smooth, however, as to avert considerable short-term costs. Hence they should not give rise to serious moral hazard.

For countries that build up excessive debt burdens, official lending in a crisis will not provide lasting relief, and it could give rise to moral hazard as private creditors lend on the strength of official support. However, the arrangements for sovereign workouts that have emerged over recent years are likely to prove serviceable in these cases. The world has rejected formal arrangements in favor of creating conditions favorable to bringing debtors and creditors together – collective action clauses, IMF lending policies for countries in arrears, etc. When governments faced with unmanageable debts have sought a fair resolution even without collective action clauses, they have been able to restructure debt remarkably quickly because the private sector has been inventive in finding ways to get a very high response to an exchange offer. Uruguay shows this clearly. Neither new techniques, however, nor an IMF-run process such as the lapsed proposal for a Sovereign Debt Restructuring Mechanism, nor any other set of formal arrangements is likely to achieve results when a government is defiant. One can only hope that the cost of this approach will make it rare. Interest in formal bankruptcy arrangements is likely to fade, as existing restructuring processes are refined. The most difficult problem, how to recognize when more IMF lending is not the solution and debt reduction is needed, will continue to be difficult to resolve. Countries may struggle on too long with market access artificially preserved through IMF programs. I am not optimistic of a solution to this problem.

These are the main issues on the agenda today. My crystal ball is not clear enough to see what new ones will arise. But I am sure that we will have new issues to deal with in the future. The institutions for dealing with them, the IMF and World Bank, will need to remain flexible.

3. Process

As I said at the outset, my co-authors of the Geneva Report and I looked at what needs to be done to have a better process to support international financial and economic cooperation going forward. I am not going to be able to go through the full reasoning behind our recommendations. Besides, I want you all to read the Report when it is published in September. What I will provide are the main recommendations with a bit of additional context. These emerged from an effort to find a tradeoff closer to the frontier of *effectiveness*, *legitimacy*, *accountability* and *representativeness* in global governance. Our focus was on the set of issues generally thought of as the province of the IMF. Thus we talk about the World Bank only tangentially and have even less to say about the future of the World Trade Organization (WTO), the Organization for Economic Co-operation and Development (OECD) and United Nations economic and development bodies. We reject transfers of sovereign powers to global supranational organizations. We favor evolution over revolution and in this spirit would keep the IMF as the multilateral implementing agency for international cooperation in the monetary sphere.

We do have two concerns about the Executive Board of the IMF, which could apply as well to the Bank. One is that it is not representative of today's world. 32% of the voting power and 15 of 48 Executive Directors represent the recently enlarged European Union. Even at its new size, the EU is overrepresented. The creation of the Euro has made the multiplicity of European voices around the Board table even more anomalous. Although, this state of affairs would seem to give Europe too much power – nearly twice that of the United States on votes and 7.5 times the seats at the table. In reality, the situation undercuts rather than strengthens European power while leaving Asia underrepresented. With so many voices, Europe has by most accounts much less influence on the IMF than the United States with its smaller but consolidated vote.

Our second concern about the Board is that its members are too removed from the governments they represent. We believe that in today's world it is feasible to have a non-resident Board that could meet every six weeks, with resident alternates for day to day business. This would engage the senior officials directly responsible for policy in capitals directly in overseeing the IMF. Board discussion could lead to consensus being developed in real time rather than only in messages back to capitals.

We look especially closely at the G-7 in both its Summit (now the G-8) and Finance Minister and Central Bank Governor manifestations. We see these bodies as having been effective at times in the past, but becoming less so over time with the emergence of new important players. These groups are accountable to the citizens of their democratic members but they were never representative and hence they have lacked legitimacy in the eyes of many. The G-7 as a body for dealing with adjustment issues has been effective at critical times in the past, for example at the Plaza, when it was still the G-5, because it included all of the elephants and no mice, even though it lacked a strong counterweight to the United States. The G-7 no longer includes all of the elephants since the emergence of Asia as a powerful trading area and China as an increasingly dominant trading economy alongside Japan. Meanwhile three of the G-7's European members have adopted a common currency together with nine others and should speak with one strong voice. Consequently, we call for the establishment of a Finance Ministers and Central Bank Governors G-4 – The United States, the euro area, Japan and China – to continue the process of dealing with adjustment issues. It should return to the G-5 practice of meeting discretely, normally without communiqués.

We see an ongoing role for the G-7 Finance Ministers and Deputies to deal with debt issues from the side of the principal providers of useable currencies to the IMF and shareholders whose callable capital backs the funding of the World Bank. G-7 leadership is still important for continuing to move forward on the debt problems of the Heavily Indebted Poor Countries (HIPC), as well as to deal with any new sovereign debt crises.

At the level of the Summit, we see the G-7/G-8 as having never, after the first summit (of the G-5) at Rambouillet, played as important a role in global economic and financial affairs as the attention these meetings once drew would suggest. And in recent years, leaders have spent most of their time on issues other than the global economy. The G-8 may continue to meet to deal with more political issues, but we would create a new group to consider policy requirements needed for the global economy on an ongoing basis. This would essentially be an agenda setting and agreement ratifying group - others would do the work.

We call the new group the Council for International Financial and Economic Cooperation (CIFEC). It would be comprised of finance ministers, although an occasional meeting at the level of heads of state or government might be appropriate. It was the particular people at the heads of G-7 governments in the mid 1970s who brought finance issues to the summit level. Finance issues have rarely commanded the enthusiastic attention of summit participants since then, and they would be better dealt with by finance ministers, except when extremely political issues arise. We do not see a need to have central bank governors in the CIFEC. They now, for the most part, pursue independent, reasonably clearly defined policies in a critical but narrow sphere. While no adjustment discussion is meaningful without them, they are not responsible for the broader issues that the CIFEC would deal with.

We think a small group is important for effectiveness, but we are concerned that the CIFEC be more representative than the G-7. We would strike this balance with a group of no more than 15. We would have some standing members and other rotating members to ensure that the CIFEC is representative of small countries as well as large.

The G-20, created as a broader forum by the G-7, might be seen to fill the role we intend for the CIFEC. We do not see it doing so effectively, however, in large part because of its size – forty people at the table are too many. In addition, the G-20 has not been given the support and attention from the G-7 countries, which is needed for it to play the role that we see for the CIFEC. It is important to have a global agenda setting group that is effective. So we want to try again.

We look at the response of the leading countries to the emergence of financial supervisory, regulatory and systemic issues and see much to approve of. Groups with the requisite expertise, increasingly involving the systemically important economies and not just the outdated G-10, have been created to deal with a wide range of issues. The establishment of the Financial Stability Forum, which brings a political element as well as newly important actors to these issues, was an important step that recognized the growing importance of cooperation in this area. We make some suggestions to strengthen what has been achieved, but the most important thing is to recognize the growing importance of issues in the financial area over the past ten years. This trend has been met with an ad hoc, flexible response. This sort of response is likely to be needed in new areas in the future, and we believe that a CIFEC could bring this about more effectively and more legitimately than the G-7 can.

Finally, we suggest that a newly established CIFEC undertakes a review of all of the existing groups that continue to meet, some of which play no uniquely important role. We liken the present international financial and economic scene to an overgrown English Garden. We do not propose turning it into an orderly French Garden, but it needs some serious pruning after sixty years of creating new groups and almost never terminating them. So many meetings demand too much of the time of busy officials and diffuse attention.

These are our main proposals. As I said, they embrace evolution and maintain the Bretton Woods institutional structure of sixty years. They focus more on the informal arrangements that have grown up around it. And they put particular emphasis on continued flexibility to meet changing demands.

The World Bank's Contribution to Financial Stability

Kurt Bayer

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1. Development and Financial Stability

The World Bank's mission is economic and social development and poverty reduction. The two major pillars of its activities are "Building a Climate for Investments, Jobs and Sustainable Growth" and "Investing in Poor People and Empowering Them". Since the beginning of the Millennium, the international community – and with it the World Bank - have resolved to pursue development assistance in a result-oriented way, *in concreto* by helping to achieve eight so-called Millennium Development Goals, mainly couched in quantitative targets to be reached by 2015. This was accompanied by the so-called Monterrey Consensus in which the joint responsibility of industrial and developing countries and international financial institutions for development was stipulated, whereby continued reforms in developing countries would be "rewarded" by higher and more client-oriented development assistance flows from industrial countries.

The World Bank Group provides loans and grants and insurance of around USD 24 billion annually and has an outstanding portfolio of more than USD 130 billion. This makes the World Bank one of the primary actors in monetary development assistance. Equally important, however, has the role of the Bank group as a "Knowledge Bank" become, transferring world-class know-how from all over the world to its clients.

There are a number of reasons which make *sound and efficient financial systems* in a country a priority element for sustainable growth and poverty reduction. They constitute the vehicle to mobilize savings to finance productive investment for growth; they provide the payments system for the smooth exchange of goods and services among economic actors; they provide major risk protection for households and firms; they promote the accumulation of savings and wealth in a society. And specifically, they can be designed to provide much-needed access to finance for the poor – a condition which is usually not available in emerging, and even less so in developing countries.

Weak financial systems discourage business initiative and development, increase countries' dependency on foreign financing and aid – with its concomitant volatilities – and make successful shock mitigation less likely. All these impact disproportionately more heavily on the poor who have fewer means to shield themselves against all types of crises. World Bank experts have estimated that during the last 25 years over 120 systemic banking crises have occurred in 95 countries. The costs of these crises have been estimated to average 16% of GDP, in some cases up to 50%. Aggregate losses to developing countries have been estimated to amount to around USD 1 trillion, which approximately equals the amount developing countries have received in foreign aid. But the impacts of these losses are not only temporary, as the above flow numbers might suggest. Experience with recent crises has shown that they frequently lead to heavy setbacks in social development, reduce school enrolment rates, increase poverty rates dramatically and damage human capital often in an irreversible manner – thus impeding growth and development prospects also for the next generation.

2. The World Bank Financial Sector Strategy

The above suggests that strong and resilient financial systems contribute to emerging or developing countries' growth prospects and thus to poverty reduction. It constitutes an important part of the Bank's strategy towards sustainable growth (normally contained in the 3–4 year Country Assistance Strategies) to increase the resilience of developing countries' financial systems to reduce the likelihood of crisis; to build the legal, regulatory and infrastructure framework for financial sector development and to broaden and deepen access to financial services for all levels of society.

For the last few years the Financial Sector Group in the Bank has undertaken more than 60 projects a year with an annual commitment volume of around USD 5 billion. In addition to its own activities, the Bank engages in a large number of partnership projects with major financial institutions around the world.

The World Bank has three types of instruments available for this task: knowledge products, lending and policy advice and technical assistance. The Bank develops cutting-edge analysis on financial topics in client countries and applies its world-wide knowledge in measured ways to clients. By means of Financial Sector Assessment Programs (together with IMF) and Economic and Sector Work key issues of concern in the individual countries are identified and solutions and options proposed. Loans/grants and technical assistance are used to help countries to import knowledge and pay for the creation or strengthening of regulatory systems, build institutions able to deliver better and more financial services, including asset and debt management.

In addition, the International Finance Corporation (IFC) helps finance financial sector acquisitions in emerging and developing countries, including their necessary investments into leasing, insurance, retail banking, housing finance, micro-credit to rural and urban poor, etc. the Multilateral Insurance Guarantee Agency (MIGA) has been very active in offering insurance against political risk for foreign direct investments of banks.

Major areas of World Bank involvement in Financial Sector Strengthening are improvement of the Banking Systems (including the working out of non-performing loans, creating modern financial instruments, strengthening supervision, adherence to capital adequacy principles), capital markets, insurance and contractual savings, rural finance, SME finance, micro-finance models, improvement of payment systems, natural disaster and weather insurance schemes, commodity price fluctuation insurance, and recently active efforts to help countries combat money laundering and terrorism financing.

3. The World Bank as a Partner in the Global Financial Architecture

In its statutory role of helping less developed countries to improve the standards of living of their populations, to combat poverty and to put economic growth and social development on a sustainable footing, the World Bank is part of the International Financial Architecture institutions that have grown over the past 60 years. This is not the place to discuss whether Global Economic Governance in its entirety is adequate or appropriate. The World Bank as part of the Bretton Woods institutions has come a long way. It has disbursed around USD 550 billion in credits and grants to its now over 100 client countries. Its role in stabilizing the International Financial Architecture has increased, together with the recognition of the importance of stable financial systems for sustainable growth and social development. Its commitment to help stabilize countries by introducing them to modern institutions and processes, among these very importantly a stable financial system, is part of the global effort to improve world stability, mitigate national and social tensions and improve relationships of its 184 member countries with each other.

This commitment to a better world manifests itself in a number of *partnership arrangements* where the World Bank cooperates concretely with other institutions.

Foremost among these efforts are the joint programs by World Bank and IMF to do Financial Sector Assessments (FSAPs). These serve to identify strengths and weaknesses in the financial sectors of member countries by means of thorough analysis, and to bring policy advice for improvements to these countries. The Bank has developed the Financial Reform and Strengthening Initiative (funded with USD 54 million) to be able to do provide the technical assistance necessary for FSAP and ROSC (Review of Observance of Standards and Codes) follow-ups. During 2000–2004 more than 70 FSAPs (full FSAPS and updates) have been undertaken.

The Bank participates in a number of Regulatory Bodies: it makes contributions to the revised Capital Accord (Basle 2) and to the revised Core Principles on Bank Supervision, provides guidance notes for assessors of compliance of IOSCO standards, contributes to the revision of the core principles for insurance supervision (IAIS) and has developed a template for FSAP insurance audits; it participates in the meetings of the Financial Stability Forum, has contributed to developing good practices for the regulation of pension fund managers and participates in the Financial Action Task Force (FATF) and has recently accepted the mandate to cooperate in AML/CFT; it has participated in a number of Bank Standard exercises, e.g. the Bank Insolvency Principles and Corporate Insolvency Principles, as well as in the joint conference on migrant labor remittances.

This list shows that the Bank is not only heavily engaged in its "own" activities to strengthen the financial systems of its client countries, but is also willing to share its know-how in this large number of very important global initiatives.

The activities of the World Bank experts in the financial sector field are very varied. They do not remain in the lofty realm of analysis proclamation, but attempt to develop *country-specific and context-specific solutions* "on the ground", frequently under very difficult circumstances. In all these solutions, the unique know-how World Bank experts have acquired through their work throughout the world is continually being adapted to the country in question. Lessons learned from previous experiences are incorporated into the work and conditions outlined under which circumstances and conditions which options for solutions are more likely to be effective in a given country.

A partial list of recent analyses and policy notes by the World Bank for specific regions or countries give a brief glimpse of the variety of this work:

- Islamic finance
- Health insurance design
- Agricultural risk toolkit
- Annuity products
- Housing Finance
- Corporate Governance
- Corporate Debt Restructuring
- Improving public bank governance
- Good practices for bank insolvency
- Access to micro-insurance services
- Catastrophe risk management
- Depository services
- Credit reporting and information systems
- Regulations for debt markets
- Distributional impacts of crises
- Risks of dollarized financial systems
- Solvency for developing markets

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The Bretton Woods Institutions after 60 Years – Some Thoughts on Markets, Governance and the Role of the IMF

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1. The Failures of Two Fundamentalisms

The reference here is not to religious fundamentalism. I am thinking of the fundamentalism one could find and sometimes still continues to find in economic writings. On the other end of the ideological spectrum, market fundamentalists have argued, and some continue to argue, that if markets are to do their job of allocating resources, there should be no interference from government, no public sector type decision making to counter the market. Ludwig von Mises[1], for example, argued that "the market economy …and the socialist economy preclude one another. There is no such thing as a mixture of the two systems". Friedrich von Hayek argued along similar lines: "Both competition and central direction become poor and inefficient if they are incomplete …a mixture of the two will be worse then if either system had been consistently relied upon".[2] Milton Friedman came very close to similar views, arguing, for example, that speculative behavior in foreign currency markets will always be stabilizing. Traces of the same kind of fundamentalism can be found in the views of those who see the Bretton-Woods

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1 Ludwig von Mises (1949), Human Action: A Treatise on Economics. New Haven: Yale University Press.

2 Hayek, Friedrich A. (1949), The Road to Serfdom. Chicago, IL: University of Chicago Press, 50th anniversary edition.

institutions, particularly the IMF, as colossal sources of moral hazard, undermining the discipline of free international capital markets. They tend to believe that markets, including financial markets, work well, both domestically and globally, across national borders. The role of governments and international treaties should be to enforce property rights and perhaps provide a basic social safety net, and it should stop at that.

On one end of the ideological spectrum there were those believing in the virtues of central planning. They enjoyed their heydays in the late 1940s and 1950s when the Soviet Union appeared to be growing very fast and catching up with the U.S.A. The fact that the first man in space was a Soviet comforted them in their belief. The famous Marxist economist, Oskar Lange, for example, became a total convert to central planning in the late 1940s, despite the fact that he had been one of the architects of a model mixing planning with markets in the 1930s. In the late 1940s, Lange argued that the advent of computers abolished the need for markets, because thanks to computers, all allocation decisions could be made by central planners working with computers.

The history of the last 60 years has proven both types of fundamentalisms wrong. Some communist countries tried to actually practice the fundamentalism of planning (the Soviet Union particularly in the 1960s and 1970s, other Eastern European countries, with the most extreme case being the Albania of Enver Hoxha.) It all ended in unmitigated disaster. Market fundamentalism, on the contrary, was never really implemented anywhere. It was proven wrong in a different way: democratic societies could not or would not implement it, because the political mechanisms at work in a democratic society would not turn the entire allocation and distribution of resources over to the unadulterated market mechanism. Throughout the twentieth century, there has been a lot of debate on the best possible balance between the domain of the market and the domain of government, but markets have always remained "embedded" in public and social institutions.[3] In fact, the share of resources allocated by the state has steadily increased since the early 1900s. The share of government in GDP of what are now the OECD countries has increased from about 10% before World War I, to an average of about 45% in the 1990s.[4] The share has stabilized over the last decade but it has not and is not declining. Even the so-called Reagan-Thatcher revolution in the 1980s did not have a significant impact on the balance between the public

[3] The term "embedded liberalism" was coined by John Ruggie in the early 1980s to describe the social market economy that emerged as the dominant socio-economic model in the western world during the post-world-war II period. Ruggie, John G. (1982). International Regimes, Transactions and Change: Embedded Liberalism in the Postwar Economic Order. International Organization. 36 Spring.

[4] See Tanzi, Vito, and Ludger Schuknecht. (2000). Public Spending in the 20th Century: A Global Perspective.Cambridge. Cambridge University Press, for a comprehensive study of the share of government in the national expenditures of a large number of countries.

and the private sphere in the advanced western economies. Privatization of parts of the public sector did become more widespread and the share of the public sector in value-added did decline somewhat in several countries, but the share of taxes and public expenditures did not decline.

In a recent book the French economist Jean Paul Fitoussi explains the success of what I call the "social-liberal" synthesis[5] as follows:

> "On the one hand the market is governed by the principle of voting where the appropriation of goods is proportional to the resources owned by each – one euro, one vote. On the other hand democracy is governed by universal suffrage – one woman, one man, one vote. This contradiction had been perceived already at the time of the origins of political theory in ancient Greece. Our system reflects the result of an inherent tension: on the one hand individualism and inequality, on the other hand public space and equality. This forces a permanent search for an in-between, a compromise".[6]

To summarize, the history of the last hundred years has shown that there are two dimensions to the social "embedding" of the market: redistribution and regulation. Democratic societies do not accept the distribution of income which would result from the outcome produced by a particular set of endowments individuals have interacting with purely market based production and exchange. They demand that public policies achieve a certain degree of redistribution and provide a social safety for the most vulnerable. Democratic societies have also learned that markets need effective regulation and constant supervision to function well. Competitive structures cannot be assumed to exist and persist naturally, technology and information economies often require large scale organizations, so that difficult competition and principal-agent problems arise which cannot be ignored by public policy.

What does all this have to do with the 60 years of the Bretton-Woods institutions? A lot, I believe. Over the last few decades the domain of the market has become much more global. Production is increasingly planned and carried out in integrated networks across the world. Financial markets have become even more integrated. All this is being made possible in accelerating fashion by modern communications technology. We are in the midst of a tremendous revolution in the

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[5] Derviş, Kemal. (2004). A Better Globalization: Perspectives on Legitimacy, Reform and Global Governance. Center for Global Development unpublished manuscript (forthcoming). Washington, D.C.

[6] See Fitoussi, Jean Paul. (2004). La Democratie et le Marché. Paris. Grasset. p 46.

nature and use of knowledge. Everywhere, citizens are affected by economic events and market driven decisions happening far from where they happen to live.

At the same time, in the political domain, liberal democracy has triumphed. Within nation states, a political system giving each citizen equal weight and equal value through free and democratic elections, which are essentially based on a one-citizen one-vote principle agreed on today by a very large part of humanity. The ideological triumph of democracy, which is linked to the triumph of the principle of human equality, is not easily compatible with a global system where human beings are "equal" in the sense of having equal democratic rights *within* national borders, but remain very "unequal" *across* these borders. Pressures are rising for the *global market* to be "embedded" in a *global community* in a manner similar to what happened within individual countries. The global market too must be regulated and the results it leads to must be partly altered by redistributive mechanisms for market driven globalization to be accepted by the majority of those affected by it. Markets may be good for national growth as well as for global growth – but that is not enough for their results to be accepted as legitimate.

We are of course very far from a global community that resembles what exists at the national level. It will take time for the global market to become "embedded" in a manner described by Ruggie in the context of national markets. Responding to a genuine and deeply legitimate demand, the process of building global public institutions has started long time ago, when the founding fathers gathered with great foresight at Bretton-Woods and tried to lay the foundations for a world economic order that would spare their children and grandchildren the horrors of war. It continues with the pursuit of the millennium development goals and with the debate on improving global governance. I believe that it is against this broad background that one should discuss the role and future of the Bretton-Woods institutions six decades after their conception. The notion of embedding the market goes beyond the valid but more narrowly economic notion of public goods. The provision of public goods by governments corrects for market failure, improves economic welfare and is desirable and justified on purely economic grounds. Embedding the market in democratic and public institutions adds legitimacy and acceptance to the socio-economic outcomes created by market mechanisms regulated and altered through democratic processes. It is within this philosophical and historical approach that I want to share my thoughts, briefly, on the role of the International Monetary Fund (IMF) in the coming years in the second part of this paper.

2. Some Thoughts on the Future Role of the IMF

2.1 The Surveillance and Crisis Modes

Considering the role of the IMF within the overall framework of global economic governance one can quickly distinguish two related but distinct activities that are currently ongoing:

- Economic surveillance including the elaboration of globally acceptable and desirable standards and codes accompanied by the pooling of knowledge and experience

- Rescue operations, in the form of work-outs when countries are facing acute balance of payments and related debt rollover problems.

Both functions of the IMF are valuable and fulfill some of the "embedding" role that we referred to above. Market fundamentalists have questioned the usefulness of both functions. Some argue, for example, that private financial markets alone with private rating agencies, financial institutions and consulting firms could carry out activities resulting in "surveillance" and could develop and spread the required knowledge and information. Changes in credit ratings could constitute the kind of endorsement or warning that comes with an Article IV consultation. The "short term alarm clock" models developed by private institutions such as Deutsche Bank, Goldman Sachs or others would alert markets to impending financial "events" and the discipline fear creates would help prevent serious crises. Good policies would be rewarded by greater capital inflows and lower interest rates. The private sector itself can create and disseminate knowledge.

There is truth and merit in these propositions. The side effect of the increased transparency that is being demanded from governments worldwide, has been that the IMF no longer has the same privileged access to timely information that it did have only a decade ago. Central Banks now publish their balance sheets on websites, and government commitments to the Fund contained in "letters of intent" that used to be top-secret documents, can be read by everyone the day after board presentation. It is also true that private institutions able to process and analyze information have developed in many more countries, including in many of the emerging markets. Information is no longer restricted to operators in a few of the richest countries. Nonetheless there remains substantial value in a public international institution complementing market operators and providing a kind of anchor to all these market –driven surveillance, monitoring and analysis. The IMF has the advantage of a huge accumulation of institutional memory and skills spanning a broad set of issues that remains unmatched in the private sector. The very fact that it is not driven by short-term profit concerns allows a special perspective that differentiates the analysis carried out by IMF staff from what is produced elsewhere. Private financial markets are too often driven by herd instinct rather than sufficient analysis of fundamentals. The IMF can provide a longer-term perspective and greater attention to fundamentals. Finally, Article IV consultations and other special IMF missions provide for a formal and accepted framework where governments engage with representatives of the international community as a whole, a process which has acquired a certain degree of legitimacy and continuity.

The best way to look at private sector produced information and monitoring, and IMF monitoring and surveillance, is as *complementary* and *mutually reinforcing* mechanisms that help make information more transparent and improve the overall quality of the analysis that is available. The public nature of the IMF and the absence of the profit motive help to make the IMF into an anchor with a time perspective that helps lessen (although it cannot abolish) the tendency to overreaction and overshooting that so often characterizes private financial markets. A final point here is that it would be very desirable and would increase the legitimacy and effectiveness of the process, if the rich and powerful countries themselves showed stronger interest in and support of the process of consultations with the IMF. The contribution that IMF surveillance and monitoring can make to the quality of information and to global stability is a public good from which every country can benefit in the long-term, even if it sometimes comes with short-term costs. IMF monitoring can also be a form of embedding the global market, provided the governance of the IMF is itself perceived as legitimate and as contributing to greater global democracy. On this, there are, of course, big question marks.

The second ongoing activity of the IMF takes the form of rescue operations or "work-outs" for countries that are facing payments difficulties. For a long time in the past, the word "payments" would officially have had to be preceded by the word "foreign". Over the last decade, however, with a general movement to flexible or floating exchange rate regimes, public debt sustainability and foreign payments problems have become inextricably linked and a "crisis" calling for IMF help is almost always simultaneously a public debt and foreign payments crisis.[7] Causality works in both directions: fears of a public sector "debt event" lead to pressure on foreign payments due to capital outflows and increasing risk premia; sudden large depreciations lead to losses in the banking and corporate sector that may have to be socialized as well as increases in foreign exchange denominated

[7] The form taken by recent crises in Asia, Russia, Latin America and Turkey always involved massive pressures on the exchange rate and loss of foreign reserves and public debt worries. It is true that public debt levels in Asia were much more manageable than elsewhere but huge and persistent devaluations always threaten the entire financial and corporate sectors of an economy and sooner or later generate pressure on the public sector balance as governments have to socialize at least parts of these losses.

public debt payments that can trigger "debt-event" fears. The second major role of the IMF is to help countries overcome such a crisis. The frequency and severity of crisis increased significantly in the period from the early 1990s to the early 2000s. One of the severest among these crises was the crisis that hit Turkey in the winter of 2001 leading to a halving of the value of the national currency in a few weeks and a close to 8% contraction of GDP during the crisis year.[8]

I cannot here review the whole debate on the role of the IMF in crisis type situations. It involves the arguments about "moral hazard" (availability of rescue finance leads to imprudent behavior by both creditors and debtors), about conditionality (what kind and how intrusive) and the amount of resources that should be deployed (too much resources increases system-wide moral hazard, too little is useless). These arguments are linked and the debate should be conducted linking the moral hazard, conditionality and size of financing dimensions. I want to make some key points drawing lessons from the Turkish crisis which are, I am convinced, of relevance for most crisis situations in which the Bretton-Woods institutions are called to the rescue.

1. One cannot dismiss the moral hazard argument. The availability of rescue finance does encourage risky behavior on the part of both private lenders and policy makers. It is not clear, however, to what extent this moral hazard is directly linked to the existence of the IMF. A severe crisis in an important country imposes political and economic costs on the world community as a whole and it is not unreasonable to think that if there were no IMF some other form of rescue operation would materialize. The IMF provides a more predictable and less politicized mechanism for work-outs that otherwise might occur with G-7 or bilateral type money.

2. A crisis imposes tremendous costs on a country and on the political establishment that is perceived as responsible even when there is a successful work-out. In Turkey real incomes fell by more than 10% in 2001 and none of the political parties that were in power at the time of the beginning of the crisis were able to get into the new parliament elected in 2002. Their combined share of the vote came down from about 53% to about 15%. Given such a huge political cost one should not exaggerate the importance of moral hazard on the behavior of policy makers. The danger may be more serious with regard to creditors.

[8] The author left his position of Vice-President of the World Bank to take over as Minister of Economic Affairs in Turkey on March 13, 2001, three weeks after the February 22 collapse of the currency, and remained in office a year and a half, until mid-August 2002.

3. The IMF (with some support from the World Bank) did provide decisive financial support with net use of IMF resources amounting to close to 10% of crisis year GDP over 2001–2002, and outstanding Fund credit reaching 1685% of quota at the end of 2002. The macroeconomic framework that Turkey agreed on with the IMF in two stages (May 2001 and February 2002) was realistic and contained a margin of safety. It was not "underfinanced".[9]

4. Part of the financing came from a huge domestic fiscal adjustment with a primary surplus of 5.5% of GDP and the promise of continued strong fiscal policy thereafter. The fiscal target of 5.5% was met during the crisis year.

5. The macroeconomic efforts were combined with deep and wide-ranging structural reforms attempting to transform the basic institutional and legal infrastructure of the economy. We did not pursue a macro-equilibrium first structural reform later strategy, but took advantage of the national self-preservation reflex generated by the crisis to start the transformation of the whole socio-economic system of the country towards one that could lead to better economic performance and transparency.

6. Conditionality was comprehensive and reflected the will of the Turkish economic team to seize the opportunity for structural reforms. Conditionality *helped* in speeding up the reforms and encouraged greater coordination within the Turkish government. It *hurt* by giving the program a foreign flavor diminishing the degree of political support, despite the fact that it was driven more by domestic reformers than by IMF advice.

7. Together, very strong fiscal policy with quarterly targets actually met, decisive IMF financial support and ambitious structural reforms, achieved the critical result of restoring confidence and overcoming default fears after just nine months of program implementation. The turnaround in expectations occurred in November 2001 and growth resumed in the Spring of 2002, producing a strong rebound (GDP growth of 7.8% for 2002) which has continued into 2004.

I believe general lessons can be drawn from the Turkish experience with validity for the role of the IMF in emerging market crisis. There is little doubt that without rapid support from the IMF, Turkey would have had to restructure

[9] Note that in Turkey's case the financing came exclusively from the IMF and the World Bank. There was no parallel G-7 financing or pledges as was the case in several other countries. The amounts should be evaluated keeping that in mind.

domestic and foreign debt involving at least a partial default. While we cannot conduct a counterfactual experiment, there is little doubt in my mind that the income losses due to the much greater disruption this would have caused, would have exceeded what was experienced in 2001 by a large amount. The additional disruption would have hurt the poor disproportionately by creating even more unemployment. The crisis did lead to radical political change, but the change proceeded democratically and peacefully. Forcible restructuring and default to domestic creditors with inevitable restructuring of bank deposits, could have led to social conflict and a total breakdown of the political system. For these reasons, the intervention of the IMF in support of a strong domestic adjustment program helped prevent much greater damage.[10] It was essential that the amount of financing was consistent not with wishful thinking, but with cautious macroeconomic projections. Had it been, say, only two thirds of what it was, I have little doubt that the program would have failed. Comprehensive program conditionality and benchmarks were important in projecting decisiveness and commitment to financial markets and useful, given the IMF's financial leverage, in accelerating structural reform. What was a negative factor was the continued perception of the IMF as a G-7 or even G-1 dominated institution, a perception which caused the reform process to face very difficult moments, and which always increases the danger of policy reversals. Reforms in the governance of the IFIs that would increase their legitimacy among the broad public would greatly contribute to the effectiveness of IFI supported programs. This perceived lack of legitimacy is an obstacle to better "imbedding" of the type referred to above.

A final point is in order about the IMF in a work-out mode. Turkey's situation was such that it turned out to be possible to overcome the crisis without default and I believe this was the preferable solution. It may not be always possible, however, to avoid debt restructuring. The immediate growth potential may be too weak and/or the fiscal-political capacity may not be sufficient in relation to the size of the accumulated debt burden. In such cases, the availability of an agreed sovereign debt restructuring mechanism (SDRM) along the lines proposed by Anne Krueger and others[11]would help reduce the costs of an otherwise chaotic crisis. An SDRM should be considered as an additional tool, complementing stand-bys and work-out finance in the tool-kit available to the international community and to countries in crisis. The generalization of collective action clauses in sovereign debt instruments can take us towards the same objective if it is rapid and comprehensive enough.

[10] Note that I am here referring to the 2001 and 2002 programs. The earlier 2000 program had failed and it did not have many of the characteristics of the later program. Structural reforms were weak and gradual, the financing had been modest and the fiscal effort had been insufficient.

[11] See Krueger, Anne O. (2002). A New Approach to Sovereign Debt Restructuring. Washington, DC: International Monetary Fund. http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf

3. Beyond Surveillance and Crisis Work-Outs: A Third Function for the IMF

It is fair to say that, for middle income countries at least, the IMF's role is restricted to either, monitoring and surveillance, or to fighting an acute crisis or the threat of an acute crisis. Many emerging market countries fortunately, are not in an acute crisis or pre-crisis situation. This does not mean, however, that they do not face very difficult economic and social problems. As the fall 2003 issue of the World Economic Outlook explains in some detail[12], there is a whole group of middle income countries that have accumulated a level of public debt that appears difficult to sustain. Until the 1970s most developing country debt was foreign debt to official institutions or to commercial banks. With the development of capital markets, governments started issuing bonds in international capital markets as well as at home. Total public debt levels in the group of emerging market countries focused on in the World Economic Outlook (WEO) rose from about 30% of GDP at the end of the 1960s to about 60% at the end of the 1980s and to about 70% at the end of the 1990s.[13]The authors of the WEO define a benchmark level of public debt as a debt level that would equate the present value of expected future primary surpluses to the benchmark level of debt. The WEO than finds that the median value of such a "warranted" debt ratio would be only 25% compared to the 70% actual ratio in the group of countries under consideration. Even if one finds this methodology a bit too constraining, the fact is that there is a whole group of countries which have accumulated an uncomfortable level of public debt over the last two or three decades. These high levels of debt combine with the volatility and herd behavior characterizing international financial markets to make these countries "structurally vulnerable". These countries with debt ratios well over 50% and where the debt has relatively short maturities, also have a history of crisis or near crisis situations the memory of which contributes to maintaining very high real interest rates. This combination of factors leads to a situation of perpetual vulnerability with the underlying fear that an external or internal shock could lead to a "debt event". A confidence crisis could also be triggered by contagion from a debt event in a different country.

To forestall crisis this type of emerging market economy has to run a fiscal policy with large primary surpluses and continuously pay a high risk premium on outstanding and new debt. Emerging market countries with a history of crisis and with public debt to GDP ratios in the 50% to 80% range need primary surpluses in the 3% to 7% range and pay real interest rates on domestic currency denominated

[12] See IMF. 2003. World Economic Outlook. September 2003.

[13] The group contains the countries that are in the Emerging Market Bond Index (EMBI) in early 2002 and a few others.

debt in the 10% to 20% range.[14] Both the large primary surpluses and the high real interest rates exert downward pressure on the growth of GDP, which, in turn, makes it more difficult to reduce the debt to GDP ratio. In this group of countries, fiscal policy tends to be pro-cyclical rather than anti-cyclical as it is in the mature industrial countries. When there is a recession in an economy that does not have to worry about a "debt event", fiscal policy can be expansionary and attempt to stimulate domestic demand. In industrial countries government expenditures increase by more than national income in a downturn – as should be the case to counteract cyclical recession and they increase by less than national income in an upturn. The same does not take place in our "typical" emerging market economy, because the income decline in a downturn tends to worsen the debt to GDP ratio creating "debt event" fears that tend to lead to a tightening rather than a temporary relaxation of fiscal policy. On the contrary, in an upturn, debt fears diminish and governments tend to want to "catch up" on their postponed expenditures. This makes fiscal policy pro-cyclical rather than anti-cyclical. While this is unfortunate it is really not possible to avoid it in countries where public debt to GDP ratios are high, because relaxing fiscal policy at a time of crisis is likely to lead to panic and deepen the crisis. When a crisis occurs, default accompanied by capital controls seems to be the only other option for such high debt countries with costs that usually would outweigh the costs of pro-cyclical fiscal policies!

This chronic fear of crisis not only reduces growth, but also has a very negative influence on income distribution and poverty reduction. High real interest rates redistribute income to the holders of liquid wealth. Social programs are difficult to fund and taxation is more regressive than it otherwise would be for fear of scaring capital and causing outflows.

While average income in the countries that share the features described above is higher than income in the least developed countries, there are large numbers of very poor people living in these countries. The success of the worldwide fight against poverty depends also on rapid poverty reduction in these high debt middle income economies.

The Bretton-Woods institutions find it difficult to help these countries. The World Bank is active and does provide long-term loans and advice dealing with many of the key structural problems. World Bank resources are very limited, however, and cannot by themselves alter the chronic vulnerability deriving from high indebtedness. The IMF, on the other hand, has had great difficulty in defining its role. The countries are not in an acute crisis and the short-term "work-out" mode is not appropriate for them. Surveillance and monitoring alone cannot achieve very much.

[14] Statistics are available in IMF staff reports for a good number of emerging market countries.

The IMF facilities that have been under discussion in the context of these not-in-crisis-but-vulnerable countries have been precautionary arrangements and the Contingent Credit Line (CCL). The latter launched with great hopes a few years ago was discontinued for lack of demand in November 2003. Work on a possible successor is continuing. Precautionary arrangements have and are being used but more in the context of exit from stand-by-programs than as an approach in itself. The reason for the failure of the CCL was that it ended up neither a "lender of last resort facility" that could quickly be drawn on at time of crisis, nor a "protection facility" that would ensure a country against the risk of crisis. Countries, which viewed themselves at low risk of crisis, did not find it desirable to go through the required prequalification process. Moreover, for these countries the CCL did not offer financial terms that were significantly more favorable that what they could obtain from financial markets. Countries at higher risk had, or would have had, trouble meeting the prequalification criteria. Some countries also feared the possibility that the potential loss of "qualifying status" due to a disagreement with the IMF on policy, or a temporary slippage in policy implementation, would send a very negative message to markets that would make things much worse. On the other hand, making access to such a facility almost automatic for a large number of countries could lead to irresponsible macro-policies as politicians would have a virtual bailout guarantee and would cause serious moral hazard problems. Keeping countries qualified to access the facility even if policies deteriorate would lead to the same kinds of problems and would make the IMF co-responsible for the development of a crisis. On the other hand, withdrawing qualification could trigger the crisis itself. These "entry" and "exit" problems could not be overcome and the CCL was discontinued with instructions to IMF staff to come up with a "reformed" proposal that could work.

The underlying problem that must be resolved is that short of an up-front negotiated debt reduction for which there is no support at all in a no-crisis situation, the problem these countries face is structural and requires a *long-term* approach. It is not primarily a "contagion" issue as had been assumed in the context of the CCL, but a problem of excessive indebtedness of a whole group of countries in the context of international capital markets that are highly volatile and function in the form of "surges and droughts", increasing the vulnerability of these countries.[15] The World Bank alone, given its current resource base, cannot address the problem. The IMF has more resources but is not supposed to be an institution dealing with long-term structural problems.

To correct the problem we need a long-term work-out approach in the form of support for long-term growth and debt reduction programs which would have the

[15] The term is due to French-Davis, Ricardo, and Stephany Griffith-Jones. (2003). From Capital Surges to Drought: Seeking Stability for Emerging Economies. New York, NY: Palgrave Macmillan.

objective to gradually but surely reduce the debt indicators and thereby vulnerability and high real interest rates. The best way to develop such an approach would be for the World Bank and the IMF to work closely together. Significant long-term and relatively low cost resources would have to be made available so that countries borrowing these resources could use them to substitute more costly short-term debt and thereby achieve debt-reduction in a gradual fashion, which would not be disruptive. There would have to be substantial conditionality to avoid moral hazard problems and to ensure that overall policies are strongly supportive of rapid growth, the other key determinant of positive debt dynamics. In some ways such an approach would complement the Poverty Reduction Strategy Papers/Poverty Reduction and Growth Facility (PRSP/PRGF) approach that has been developed for the poorer countries with appropriate difference reflecting the circumstances of the highly indebted middle-income countries. The details in terms of funding, cost, coverage and specifics about IMF-World Bank cooperation would have to be worked out. What is critical is to recognize that the issue is not just the danger of contagion but the fact that the accumulated burdens of the past and the nature of financial markets have left a number of countries with a structural, chronic problem.

This problem creates systemic risk for the international economy and its resolution is therefore a global public good deserving the allocation of some common resources. The persistence of chronic vulnerability is also a key obstacle for global poverty reduction and therefore satisfies the second criterion for public policy: a solution would also lead to a more desirable distribution of income.

4. Conclusion

Sixty years after their conception the need for active and successful Bretton-Woods institutions has not diminished. With globalization, it has, if anything, increased. Their activities must "embed" the global market by helping to correct market failures (the public good providing function of public policy) and by helping to make the results of market allocations more equitable (the redistribution and poverty reduction function of public policy). It would be desirable to think about the future of these institutions explicitly in these terms and be ready to adapt their operations accordingly. We should free ourselves from the unjustified ideological pressure that developed in the 1980s and that tried to argue that the working of near "perfect" global markets made these institutions redundant. They should try to provide global public goods and aim at a better income distribution in a cost effective way and with approaches appropriate to the problems, as they exist or arise. If this requires radical change, so be it. It may be, for example, that much greater integration between the IMF and the World Bank is the appropriate response to the need for a longer term perspective combined with greater resources to reduce chronic vulnerability. The changes should include changes in the functioning of governance, which reflect the need for greater global democracy, participation and legitimacy. Regulation and redistribution can only be successful if the institutions that implement these policies are perceived as both efficient and legitimate. The international community owns these institutions. It is therefore up to all of us to help them face the new challenges of a new century.

A Historical Perspective on the International Monetary System

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We are celebrating the sixtieth anniversary of the United Nations Monetary and Economic Conference at Bretton Woods, New Hampshire. I should start by saying that Bretton Woods now carries a rather mixed connotation: some see it as a triumph of international cooperation and consensus building, while others judge it to be the source of a mistaken (restrictive) approach to international capital account movements.[1] It may of course have been both at the same time. Ten years ago, the positive elements were still emphasized rather more than the negative; today, perhaps largely as a result of widespread disillusion with instabilities produced by fixed exchange rate regimes, most commentators place their emphasis the other way round. Indeed in an influential book with Luigi Zingales, Raghuram Rajan, who subsequently became the International Monetary Fund's (IMF) chief economist, described Bretton Woods as a rather unhealthy compromise, which created in many countries an insulated *relationship capitalism* (that might be described as *crony capitalism*) in which: "Productive firms that were not in political favor could not get finance. Capital controls also took away a significant source of budgetary discipline on governments, thus giving them leeway for constant intervention in the economy."[2]

In fact, Bretton Woods at the time was conspicuously incomplete: it was supposed to consist of three pillars, only two of which actually became reality, the International Monetary Fund and the World Bank. They were supposed to give concessions on the monetary side to the rest of the world, while the United States imposed trade liberalization through the third pillar, the International Trade

[1] I have presented both versions: the former in International Monetary Cooperation Since Bretton Woods, 1995, the latter (with Michael Bordo) in Haberler versus Nurkse: The Case for Floating Exchange Rates as an Alternative to Bretton Woods (2002), pp. 161–182.

[2] Raghuram G. Rajan and Luigi Zingales, Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity, 2003, p. 243.

Organization. But ITO was left until after the end of the World War, and was consequently stillborn.

1. Rules and the International Monetary System

The world economy after the Second World War was rebuilt on the basis of systems of rules and complex institution-building, but only for some areas.[3] One way of thinking about the economic story is to regard rule-building in two critical areas as moving in different directions. During the interwar period, international discussions on international cooperation foundered because trade negotiators believed that while tariff reduction and quota elimination might be desirable, there was no point in discussions until a stable monetary system had been created. Without stable monetary order, the use of trade measures to stem the export of pernicious deflation could be justified as a desirable second-best measure. On the other hand, the monetary discussions foundered because of reluctance to make agreements while the vicious spiral of trade protection was still underway. During the Second World War, the U.S.A. made it clear that it was not prepared to negotiate on trade liberalization that it saw as necessary to postwar peace, and as a result, all the diplomacy concentrated on a framework of monetary rules (at Bretton Woods).

The rule-based monetary order disintegrated in stages between 1968 and 1973. The functions of the IMF, the major institution charged with policing the rules of Bretton Woods, changed very dramatically. Its major task turned out to be plugging market failures left by the newly invigorated capital markets: in practice a great deal of attempt at crisis prevention and a great deal of experience in crisis resolution.

A consensus gradually emerged for U.S. administrations that attempts at international monetary coordination were pointless and counter-productive: like the Bretton Woods order, they restrained monetary policy in a sub-optimal way and led to undesired outcomes. Thus, the experience of the 1978 Bonn summit, or the 1985–87 negotiations and semi-agreements about appropriate exchange rates were generally viewed as discrediting the idea of negotiating about exchange rates. The mantra of all administrations since the 1980s is that exchange rates are set by the market.

On a global level, the rule-based system disintegrated, though there was a regional counter-movement in Europe. The moves to closer European monetary integration, with the elaboration of a system of rules at first very reminiscent of

[3] The classic account of the postwar order is by Richard Gardner, Sterling-Dollar Diplomacy; the Origins and the Prospects of our International Economic Order, 1969. See now G. John Ikenberry, After Victory: Institutions, Strategic Restraint, and the Rebuilding of Order after Major Wars, 2001.

Bretton Woods, actually took place at moments of disillusion about the global scenario. Thus, the European Monetary System was established in 1979, in the aftermath of the abortive Bonn summit; after the Plaza, the Europeans moved to agreed on principles for currency intervention for the European Monetary System (EMS) with the Basle-Nyborg agreement in 1987; and the final impetus to monetary union was given by the non-synchronous experience of recession in the U.S.A. and Europe in the early 1990s.

The postwar period produced a great expansion of trade that is fundamental to the story of increased prosperity. Trade became institutionally more regulated. The General Agreement on Tariffs and Trade (GATT) generalized bilateral agreements, then produced general tariff reductions in the 1960s Kennedy round, and then became fully institutionalized as the WTO in 1996. Many observers are surprised by the apparent willingness of the U.S.A. to accept rules in this area at each stage of the development of a rule-based order. The story of trade opening can be read as a suspense drama, with a new twist to the narrative on almost every page. The GATT was a compromise. It achieved its biggest successes in the 1960s, largely at the cost of reducing its extent so as to exclude some of the most contentious trade items – textiles and agricultural products. By the 1970s, after the collapse of the Bretton Woods par value system, most writers agreed that the GATT was moribund. The Tokyo round was protracted and spotty. In the mid-1980s, the leading experts concluded that the GATT was *in a state of breakdown*. The ministerial meeting of 1982 had failed. The Uruguay round looked doomed to failure as the United States and the European Community became locked in a politically complex struggle over agricultural pricing and subsidies. Even in 1993, on the eve of the final agreement of this Round, a major text produced by a GATT official had as its theme "the weakening of a multilateral approach to trade relations", "the creeping demise of GATT", and the fact that "the GATT's decline results from the accumulated actions of governments." [4] But then came the astonishing extension of multilateral principles to intellectual property, trade-related investment, and the creation of a more complete conflict resolutions procedure and the institutionalization of multilateralism in the World Trade Organization. At that time, the commentators were skeptically insisting that the United States would ignore the new institution, and instead continue a unilateral exercise of power through the application of Super 301. But when the first ruling came against the U.S.A., the U.S.A. accepted it. In 1998, everyone gave reasons why the financial services agreement could not be realized. Then, apparently unpredictably, at the last moment it came about. The U.S. steel tariffs would destroy the World Trade Organization (WTO), but then the U.S.A. gave in. Rules still ruled.

[4] Patrick Low, Trading Free: The GATT and U.S. Trade Policy, 1995, p. 247.

How can we explain this development toward rules in trade and away in the monetary domain? In the 19th century era of globalization, there were no mechanisms for agreeing international rules on either trade or money: this was a decision for nation-states. There were plenty of other international agreements: on weights, standards, postal systems, the treatment of prisoners of war, the International Red Cross. The one attempt to provide a common monetary standard, the International Monetary Conference summoned by Napoleon III in 1867, was a miserable failure.

In the earlier age of worries about globalization at the turn of the 19th century, a backlash began. The nation-state appeared as a protective carapace against the ills flowing from global integration, and in the end evolved restrictions on migration and high levels of trade protection. When national protection became the major priority of most countries, in the 1920s and 1930s, the world became both poorer and less safe. There was a vicious cycle, in which external forces were blamed for loss and disaster, and high levels of trade protection destroyed national prosperity.

It was in response to this failure that the need for international agreement on a framework of rules for international integration became apparent. Rules on trade were designed to lock in solutions to Olsonian collective action problems: to the tendency of powerfully articulated particular interests (for protection) to assert their primacy over a much less forcefully developed sense of a general good lying in trade opening.

Monetary questions by contrast are much less vulnerable to capture by particularistic rent-seeking interests. The monetary rules of Bretton Woods were not devised to solve collective action issues *within* countries, but rather to deal with coordination problems *between* countries. They followed from the articulation of conflicting national strategies: in particular, the fixed exchange rate regime was generally explained by the need to prevent nations indulging in competitive *beggar thy neighbor* devaluations of the kind that had occurred in some instances in the 1930s (notably in Japan after 1931).

Most countries have avoided the interwar sort of backlash in the second half of the 20th century, although their citizens had the same angst. The changing of employment patterns is a constant accompaniment of growth. In the early 1970s and again in the 1980s U.S. workers and producers were upset about the loss of jobs to Japan. Some of the most skilled jobs, in automobiles, were lost; household appliances like TVs were no longer made in the United States. On each occasion, the administration tried to respond to the job loss worries not by trade restrictions, but by exchange rate alterations that would make the U.S. products more competitive, in other words by a kind of echo of 1930s style solutions: first the end of the gold convertibility of the dollar in 1971, and then in 1985 the Plaza agreement to depreciate the dollar. Monetary and exchange rate policy initiatives offered a way of absorbing adjustment pain. The focus of trade discontent was shifted to the monetary arena in a way that helped to undermine the legitimacy of institutional ways of regulating the international financial system.

The use of monetary policy and exchange rate adjustment to deescalate trade conflict is harder today, since many of the countries whose products are entering the United States either formally or informally peg their own currencies to the dollar. (Japan, notably, is classified by the IMF as having an *independent float* but in practice has a vision of where its exchange rate should be.) In practice, over half of the world's population and over half of the world economy is more or less informally associated in a sort of Bretton Woods system, but without the rules for behavior and adjustment of the original order.[5]

Governments still feel that they need some response in an attempt to *feel the pain*, and to show that they are doing something. Like the Bush administration they adopt tariffs that may then be over-ruled by the WTO. In this way they do nothing very harmful, but point out to the electorate that their hands are tied by international agreements and institutions. But this sort of action itself then produces a new kind of backlash, against the international institutions.

Trade problems were in fact in the post-1945 world routinely dealt with by shifting the emphasis to the monetary arena. The world has developed its institutional arrangements in the setting of globalization by making them harder in the trade arena and softer in the monetary one. In the future the offloading of adjustment problems to monetary policy will be more difficult (because of widespread Asian exchange rate pegging) and the trade system will be in consequence more vulnerable.

2. International Capital Flows

The key element of the Bretton Woods system, which allowed the formulation of the rules, was the widespread consensus on the desirability of controlling and restricting the movement of capital. Conversely, the major development which is usually held to require movement to a floating rate system is the development of large international capital flows. Since the 1990s, these have become more extensive, but also more various: they are no longer limited to bank credits mostly to public sector borrowers, but involved portfolio investment and FDI. From the standpoint of capital flows, the world can be split into three groups: at the ends of the spectrum, there are on the one side well developed industrial economies, and on the other poor economies, in which capital inflows play no substantial role. In between, there is a group of countries with rapid growth and good prospects for the

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[5] Especially Michael P. Dooley, David Folkerts-Landau, Peter Garber, An Essay on the Revived Bretton Woods System*,* 2003. The lessons are drawn in Martin Wolf. Why the Fed is Forced to Fuel a Global Boom. 2004. See also the recent critique of Barry Eichengreen. Global Imbalances and the Lessons of Bretton Woods. 2004.

future, but a limited capacity to borrow (what Reinhart and Rogoff have diagnosed as *debt intolerance*) and no ability to develop long term markets in their own currencies.[6] These economies are vulnerable to crises of confidence.

Deep capital markets and well-developed financial institutions are generally recognized as a prerequisite for opening to international capital flows. But it is clear that many countries with strong chances of impressive economic growth do not have such institutions, and are consequently very vulnerable to financial crises as capital flows are abruptly reversed. Indeed in the wake of the 1997–98 Asia crisis, there is almost a new consensus on emerging markets that the price that is paid for premature capital account liberalization is too high.

This view may be too cautious: some very successful economies grew dynamically, but with repeated interruption by severe financial turbulence. This was the case with the United States in the later 19th century, where there existed a very dynamic instability, but also of Korea since the early 1960s. Repeated crises, in the mid-1970s, in 1982, and then again in 1997–98, were accompanied by reform, a reorientation of economic policy priorities, and a new type of growth. Chile's path to reform and economic opening was also marked a major crisis in 1982–83.

But there are two caveats: first, widespread contagion is obviously damaging on the world level and has at some moments, notably 1982 and 1998, threatened the global financial system. Secondly, even in an isolated national context, financial crises can be deeply destabilizing, especially in conditions where there is inadequate political stability. As a consequence, the policy debate has shifted from a narrower concern with purely financial measures to a much broader concern with institutional and political capacity: measures of corruption, the relation of the central government to provincial authorities, capacity for enforcement, transparency of the financial and economic system. The consequence is that it is useful to think of mechanisms to enhance stability of *emerging markets* – where markets and political institutions are not yet very deep.

3. Conditionality and the International Monetary System

The substitution of international mechanisms as credibility or commitment devices in place of absent deep domestic markets may offer a role for the IMF, but it is a very difficult and problematic one.[7] Conditionality can be described as a way of lending not only money but credibility through effective policy reform. Keynes's original vision for Bretton Woods did not need this, since there were no capital flows; and he wanted in consequence an entirely automatic Fund, in which

[6] Carmen M. Reinhart, Kenneth S. Rogoff, Miguel A. Savastano, Debt Intolerance, 2003.

[7] See Ashoka Mody and Diego Saravia, Catalyzing Capital Flows: Do IMF-Supported Programs Work as Commitment Devices?, 2003.

financial resources would simply be made available as in a sort of blind credit cooperative. But Keynes was over-ruled on this.

At first, the idea of policy reform was relatively simple, but it has become increasingly wide and complex. The problems involved in the linking of lending with conditionality and policy reform are not unique to the IMF's operations. They are inherent in any attempt to subject lending to conditionality. The League of Nations programs for Hungary and Austria in 1922 and 1923, for instance, raised exactly the same issue, and the criticisms of them as excessively harsh and intrusive on national sovereignty precisely prefigure later debates. The external control imposed on politically fragile states emerging out of the postwar breakup of the multinational Habsburg Empire was so extensive and tough that it constituted a deterrent to embarking on similar programs in other states. Instead, countries attempting to stabilize their currencies in the mid-1920s turned to the less *political* capital markets, with the result that, as a general principle, the League's conditionality was counterproductive. A reaction against the experience of the League made some of the architects of the Bretton Woods system, particularly John Maynard Keynes, desire a more automatic Fund. But the principle of conditionality – Keynes called it in a memorable phrase *being grandmotherly* – soon reasserted itself in the lending of the new institution.

For the IMF, conditionality became an increasingly sensitive issue in the 1960s and, above all, in the 1970s for the following reasons. First, because quotas were not raised in line with the dramatic expansion of world trade, higher levels of lending in relation to quotas were required, with consequently increased conditionality. At this time, there was a very strict view that conditionality should be proportional to the extent of quota borrowing, with every tougher measures required as quotas were exceeded. Second, the expansion of capital markets, which had been completely unanticipated at the time of the Bretton Woods conference of 1944, offered an alternative source of capital. The result was that conditionality applied only to some debtor countries, and the concept of countries *graduating from* the IMF became increasingly popular. Here, however, the skittishness of markets soon produced some unpleasant surprises. Before the outbreak of the 1982 debt crisis, many finance ministers and bankers had considerable confidence that the IMF was irrelevant to all except the poorest countries. Similar beliefs gripped the markets before the 1997 outbreak of the Asian crisis. Third, conditionality became more complex in order to avoid unintended consequences in programs. Previously, for instance, because of the pressure exerted by powerful political and civil service lobbies, fiscal conditions had often led to big cuts in government investment but very little reduction in government consumption. As a result, economic prospects worsened. Programs therefore began to specify elements in public spending – public sector pay guidelines, investment levels, and the like. Such an expansion of activities inevitably brought the IMF into the political domain.

The big capital account crises of the 1990s involved much larger amounts of support relative to previous crises. Mexico in 1995 drew 688% of its quota, Korea 1939% in 1997–98, Argentina 800% in 2001, and Turkey 1330% in 2002. Before the 1990s, there had been an inclination to give too little in order to give incentives to program countries to make adjustment and reforms. When the emphasis shifted to reassuring nervous markets in a capital account crisis, the priorities were reversed, and stabilizing the expectations of the markets would involve the assurance of so much support that speculators could not take a position against a country or currency and hope to succeed. This function had an analogy to the role of central banks in national economies as lenders of last resort, an analogy that was controversially drawn by the IMF's First Managing Director Stanley Fischer. The parallel is sometime made to the Colin Powell doctrine about military intervention: that it only makes sense if conducted with massive force.

The aftermath of the big bailouts in the 1990s is acutely controversial. The immediate criticism, which was probably overstated, was that it produced a moral hazard problem. In the view of Milton Friedman, for instance, the 1995 Mexican program produced the Asian crisis of 1997 because investors assumed a Fund guarantee. This may have been some part of investors' calculations, but they were fundamentally impressed by the idea of an *East Asian miracle* that they should buy into. There is an analogy with the development of the stock market boom in industrial countries the late 1990s: some of it may have been driven by the idea that central banks (and in particular the Federal Reserve System) would support a certain level of the market, but mostly it was driven by a vision of a New Economy.

The real problem came from the size of the rescue operations, the strain that these brought for the IMF's resources, the fact that as a result such operations could not be envisaged for a large number of countries simultaneously. In particular in 1998, after the Russian crisis the realistic belief that the Fund was near to the end of its resources increased fears of a generally contagious crisis. The conflict between a aim of massive response and the limited financial capacity of the IMF brought an element of intellectual incoherence to the whole approach, that was particularly visible in the stance of the United States. Paul O'Neill as Treasury Secretary repeatedly attacked the idea of *big bailouts* in principle, but then went on to advocate them very forcefully in particular cases, often in the face of resistance from other G-7 countries who wanted to interpret them as political opportunism.

In the 1990s, this view of the IMF and its role changed dramatically. In large part, this was a consequence of reflections on the collapse of communism and on the links between political and economic reform. In the 1980s, many political scientists believed that economic reform was more easily achieved by authoritarian regimes. The experience of Central Europe, in particular, completely reversed the general understanding of the link between economic liberalization and political democratization. In the new picture, only a country whose government was sustained by a deep reserve of legitimacy would be able to bear the pains associated with adjustment.

This change had repercussions for the concept of conditionality. If there was less room for a benevolent authority in imposing economic reform, this would also mean questioning the traditional role assigned to the IMF. Instead, the issue of *ownership* became central.

The collapse of the centrally planned economies or (in the case of China) their movement toward the market was the last stage in creating a new consensus about economic policy, frequently but misleadingly referred to (in a phrase coined by John Williamson) as the *Washington consensus*. The consequence has been an increasing homogeneity of political outlook, as well as of the economic order. Indeed, one key insight is that the two are linked: that economic efficiency depends on a functioning civil society, on the rule of law, and on respect for private property.

The post-cold war world has quite different politics. There is no longer a lineup of East versus West, in which pro-Western regimes automatically obtain support, regardless of their levels of efficiency and competence and probity. Rather, the international community is adopting a much more interventionist stance in which the logic that associates economic and political change is taken more seriously. The result has been the forcing of a much quicker pace of economic reform in some countries (for example, Egypt, which until the early 1990s largely resisted attempts to liberalize); the disintegration of the political order in others (the collapse and defeat of Mobutu's Zaïre); and the descent into the status of international pariah for others. The striking change in this area is that there is no longer an acceptance of domestic political inefficiency, corruption, or oppression.

The most visible product of the new political environment of the 1990s is the concern of the Bretton Woods institutions with *governance*. In August 1997, a new set of guidelines promulgated by the IMF's Executive Board instructed the staff that, in policy advice, the IMF "has assisted its member countries in creating systems that limit the scope for ad hoc decision making, for rent seeking, for undesirable preferential treatment of individuals or organizations." The IMF suggested that "it is legitimate to seek information about the political situation in member countries as an essential element in judging the prospects for policy implementation." At the same time, these guidelines also preserved the nonpolitical vision of Bretton Woods, requiring the IMF's judgments not to be influenced "by the nature of the political regime of a country." In particular, recognizing an obvious danger, they specify that "the IMF should not act on behalf of a member country in influencing another country's political orientation or behavior."

The IMF's interest in governance was already reflected in a number of very high profile decisions in 1996–97. Conditionality has come to the fore in each of four completely new areas. First, military spending had never been a topic of explicit discussion by the IMF in the era of the cold war. For instance, in the early 1980s, in the context of a discussion of a large IMF program with India, the Deputy Managing Director (DMD) stated that the discussion of military spending had to be avoided, in that this was an issue which touched on the core of sovereignty. Since 1993, however, it has been discussed in the IMF's *World Economic Outlook* reports as a major problem of misallocation of resources. In a number of cases, notably those of Pakistan and Romania, it became a central element in IMF discussions. Second, corruption is explicitly addressed: in Africa, but also in Indonesia. Third, so also is democracy addressed, although there is no reference to democracy in the IMF's Articles of Agreement (unlike those of the European Bank for Reconstruction and Development). Fourth, especially in response to the Asian crisis, a critique developed of a feature that had previously been regarded as a linchpin of Asia's economic success – the concept of *trust*, or of strong *informal networks* – and that was now relabeled and condemned as *crony capitalism*. This criticism was linked to the attack on corruption, and *a stable and transparent regulatory environment for private sector activity* was laid out as the solution.

There had been some consideration of human rights issues in the past: in Poland, whose membership application was held up in the 1980s after the imposition of martial law and the internment of political dissenters; or, more discreetly and subtly, in South Africa in the 1980s, where apartheid was attacked as an inefficient labor practice. But the scale of the discussion of political issues in the mid- and late 1990s is novel. To take an example: there was no discussion of political issues in Article IV consultations with Indonesia until June 1997, when these issues suddenly appear and are addressed quite directly as a need for political reform. The extension of the IMF into these areas is an immediate result of the new consensus about economic practice and of a new world political order that it has helped to produce. But it reflects something more profound – a realization increasingly shared throughout the world that the world economy, and world institutions, can be a better guarantee of rights and of prosperity than some governments, which may be corrupt, rent-seeking, and militaristic. Economic reform and the removal of corrupt governments are preconditions both for the effective operation of markets and for greater social justice. Indeed, these two results, far from being contradictory as some critics imagine, are complementary.

The new approach may produce greater global prosperity and stability. By helping to provide markets with better information, ensuring greater transparency, and limiting the irrational destructiveness of financial crises, the IMF can help markets operate more efficiently. But questions arise concerning the degree to which the IMF can be *evenhanded* in its treatment of all its members.

First, one of the most fundamental issues is the political counterpart to the criticism expressed by Paul Volcker, former Chairman of the U.S. Federal Reserve System, of IMF economic programs: "When the Fund consults with a poor and weak country, the country gets in line. When it consults with a big and strong country, the Fund gets in line. When the big countries are in conflict, the Fund gets out of the line of fire." Addressing the issues of military expenditure, corruption, and undemocratic practices is easier for international institutions in the cases of small countries, or even politically isolated countries. But it is likely to be hard and controversial in large states with substantial military and economic potential – for instance, China or Russia. Discussion of such issues inevitably plays a major role in domestic politics. In Russia, this kind of criticism of international institutions has made most effectively by liberal opposition politicians such as notably Grigory Yavlinksy. They explain the problems and failures of Russian reform programs by unwillingness of the international community to go far enough in attacking corruption and in imposing reform from the outside. In other cases, conditionality will be interpreted as a blatant attempt to impose Western values in the hope of restraining or even crippling potential competitors (a criticism frequently voiced, for example, by Mahathir Mohamad, the former Prime Minister of Malaysia).

Second, the IMF's financial capacity is limited. The amount of money involved means that only a very few big crises can be dealt with at a time. This was the near panic fear of 1998. We are clearly not yet out of the woods on this issue. Indeed it is possible to imagine in the future a program with China that could not be dealt with by an institution of the present size of the IMF. With that, the institution would be back to the dilemma of interwar institutions, such as the League of Nations or the Bank for International Settlements that attempted policy advice and stabilization but simply did not have the resources in the face of market panic.

Third, there is also the question of the IMF's institutional capacity for implementation. Some recent programs and statements also go into such issues of economic organization as the dismantling of cartels, the improvement of accounting practices, and banking supervision. On the one hand, it is easy to see the macroeconomic effects of the organizational or structural flaws criticized by the IMF. On the other hand, correcting them takes the IMF into completely new areas in which it has no previous experience. It is clearly experienced in fiscal affairs and in advising on central bank policy, but not in wide-ranging reforms of the financial sector or in accountancy. The detailed reorganization of corporate balance sheets in order to ensure greater transparency – which is incidentally also a problem in many industrial countries – is a less appropriate task for international institutions than for private sector consultants and accountants. The gains, after all, will directly benefit the companies undertaking the reforms.

Fourth, and most fundamentally, this process of adding new expectations could create a dangerous momentum of its own. Part of the discussion of the late 1990s in the U.S. Congress on an IMF quota increase involved the issue of whether to integrate environmental and labor standards into IMF programs. Congressional conservatives wanted to add clauses restricting the use of public funding (that might be held to derive from IMF loans) for abortion. Many of the IMF's member countries rightly feel that economic reform programs must be responsive to social and humanitarian concerns. But the amplitude of such an agenda may produce an expectations trap. The more the IMF is seen to extend its mandate, the more it will be expected to undertake, and, inevitably, the greater the challenge it will face in trying to live up to the demands. This is largely what happened in the 1990s: with financial globalization, the IMF seemed to be on the one hand more powerful, and on the other hand less capable of influencing events.

The IMF after 1998 clearly recognized the need to resist institutional overstretch: to ensure that its mandate is limited, clearly defined, and subject to realistic assessment of results. The review of conditionality in 2002 tried to adopt a more flexible approach, and to play up the element of country *ownership*, i.e. political responsibility for the formulation of effective policy response. But it is important to recognize that the mission creep of the 1990s was not simply the result of a bureaucratic power drive, but reflected a real difficulty in designing appropriate and credible institutions in a world in which capital moved more freely.

4. Conclusion

The problems raised by the new mobility of capital, that Bretton Woods had intended to constrain, are not capable of being simply dealt with by the adoption of a new framework of rules or laws. In that sense, Bretton Woods cannot really be reinvented; and the analogy with the trade area, which is appropriately the domain of international law-making, is not correct. But the problems are certainly real, and demand a considerable extent of institution building. This is a complex process, and not always easily done from the outside or on a global scale. Above all, it requires the elaboration of generally applicable rules if it is to be legitimate, rather than case by case interventions, which may foster discontent and resentment. Let me conclude on an Austrian note. Thinking back to the circumstances of 1944, a work which John Maynard Keynes read on his way to Atlantic City and Bretton Woods contains some useful advice. In *The Road to Serfdom*, F.A. Hayek wrote:

"Though there are no doubt many people who honestly believe that if they were allowed to handle the job they would be able to settle all these problems justly and impartially, and who would be genuinely surprised to find suspicion and hatred turning against them, they would probably be the first to apply force when those whom they mean to benefit prove recalcitrant, and to show themselves quite ruthless in coercing people in what is supposed to be their own interests. What these dangerous idealists do not see is that where the assumption of a moral responsibility involves that one's own moral views should by force be made to prevail over those dominant in other communities, the assumption of such responsibility may place one in a position in which it becomes impossible to act morally. To impose such an impossible moral task on the victorious nations is a certain way morally to corrupt and discredit them." (p. 169)

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Exchange Rate Regimes for the 21st Century: A Historical Perspective

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1. Introduction

The choice of exchange rate arrangements that countries face at the beginning of the twenty first century is considerably greater and more complicated than they faced at the beginning of the twentieth century yet the basic underlying issues haven't changed radically. In this paper I consider the subject of exchange rate regime choice from an historical perspective.

At the beginning of the 20th century the choice was obvious – join the gold standard, all the advanced countries have done it. Floating exchange rates and fiat money are only for profligate countries. At the beginning of the twentieth century, the choice I will argue is also becoming more obvious – go to floating exchange rates, all the advanced countries have done it.[1] Moreover in both eras, the emerging markets of the day tried to emulate the advanced countries but in many cases had great difficulties in doing so (Bordo and Flandreau, 2003). What happened in the past century to lead to this about face?

Actually of course, the choice today is much more complicated than I have just alluded to. Indeed rather than two options there are many more ranging from pure floats through many intermediate arrangements to hard pegs like currency boards, dollarization and currency unions.

In this paper I will look at the issue from the perspective of both the advanced countries, who generally have a choice and the emergers who have less of one and

[1] In the pre 1914 period, there were also a number of monetary unions and currency boards. Two types of monetary unions prevailed: international unions such as the Latin monetary union and the Scandinavian monetary union, which basically involved arrangements for standardizing gold and silver coins and the clearing of payments; and national monetary unions, such as the United States, Germany and Italy, which involved the complete economic and political integration of the member states with a common currency (Bordo and Jonung, 2000). Currency boards which originated in this period were run by the British and the French in a number of their colonies. (Schwartz, 1992).

who often emulate what the advanced countries have done. Section 2 surveys some of the theoretical issues involved beginning with a taxonomy of regimes. We first discuss the Mundell Fleming criterion and its two offshoots: the trilemma and optimum currency area. We then consider the approaches focusing on credibility and a nominal anchor. Finally, we look at the recent bipolar view which emphasizes credibility and financial development. Section 3 examines the empirical evidence on the delineation of regimes and their macro performance. Section 4 provides a brief history of monetary regimes. Section 5 concludes with some policy issues.

2. Theoretical Issues from an Historical Perspective

The menu of exchange rate regimes has evolved over the past century *pari passu* with developments in theory. Below, I survey some of the principal developments with an historical perspective. Before we do this I present a modern day taxonomy of exchange rate arrangements in table 1.

2.1 Modern Exchange Rate Arrangements

Table 1 contains a list of nine arrangements prevalent today. They are arranged top to bottom by the degree of fixity. Modern fixed arrangements include: truly fixed arrangements like the recent French Colonies of Africa (CFA) franc zone; currency boards in which the monetary authority holds 100% reserves in foreign currency against the monetary base, the money supply expands or contracts automatically with the state of the balance of payments and there is no role for discretionary monetary policy including a lender of last resort; dollarization which goes one step forward and eliminates the national currency completely; and currency unions in which the members adopt the same currency.

Intermediate arrangements run the continuum from: an adjustable peg under which countries can periodically realign their pegs; to crawling pegs in which the peg is regularly reset in a series of devaluations; to a basket peg where the exchange rate is fixed in terms of a weighted basket of foreign currencies; to target zones or bands where the authorities intervene when the exchange rate hits pre announced margins on either side of a central parity.

Floating exchange rates are divided into: free floats where the authorities do not intervene and allow the exchange rate to be determined by market forces; and managed floats where intervention is done to lean against the wind.

The demarcating line between fixed and intermediate arrangements is if the policy to fix is an institutional commitment. The line between intermediate and floating is if there is an explicit target zone around which the authority intervenes (Frankel, 2002).

Table 1: Exchange Rate Regimes

I. Fixed Arrangements

a)	Currency Unions
b)	Currency Boards (dollarization)
c)	Truly fixed exchange rates

II. Intermediate Arrangements

a)	Adjustable pegs
b)	Crawling pegs
c)	Basket pegs
d)	Target zone or bands

III. Floats

a)	Managed floats
b)	Free floats

Source: Frankel (1999).

2.2 Theoretical Perspectives

The traditional view on the choice of the exchange rate regime a century ago was very simple. It was between specie standards and fixed exchange rates on the one hand, and fiat money and floating on the other. The prevalent view was that adherence to a specie standard meant adherence to sound money i.e. predictable policies that maintained stable price levels (as well as fiscal probity i.e. balanced budgets) and avoiding the transactions costs of exchanging different currencies into each other. By 1900, most nations had switched away from silver and bimetallic standards and adhered to the gold standard. Fiat money and floating was considered to be a radical departure from fiscal and monetary stability and was only to be tolerated in the event of temporary emergencies such as wars or financial crises. Countries which followed fiat money and permanently floated such as Austria-Hungary, and Spain were viewed with disfavor.

In the interwar period, the return to the gold standard was short-lived, ending with the Great Depression. The return to the gold standard was preceded by widespread floating as was the period following it. The contemporary perspective on the experience with floating in the interwar was that it was associated with destabilizing speculation and beggar-thy-neighbor devaluations (Nurkse, 1944).

This perception lay at the root of the creation of the Bretton Woods adjustable peg in 1944. The currency arrangements that many countries signed onto after Bretton Woods combined pegged exchange rates with parities fixed in terms of U.S. dollars, the dollar pegged to gold, narrow bands of 2½ percent around parity and the right to change parity in the event of a fundamental misalignment. It was supposed to combine the advantages of the gold standard (sound money) with those of floating (flexibility and independence).

The difficulties that member nations had in finding a parity consistent with balance of payments equilibrium and the currency crises that attended the realignments of parities in the early years of the Bretton Woods system (Bordo, 1993), set the stage for the perennial debate between fixed versus flexible exchange rates. Milton Friedman (1953) in reaction to the conventional (Nurkse) view made the modern case for floating. According to Friedman, floating has the advantage of monetary independence,[2] insulation from real shocks and a less disruptive adjustment mechanism in the face of nominal rigidities than is the case with pegged exchange rates.

Mundell (1963) extended Friedman's analysis to a world of capital mobility. According to his analysis (and that of Fleming, 1962), the choice between fixed and floating depended on the sources of the shocks, whether real or nominal and the degree of capital mobility. In an open economy with capital mobility a floating exchange rate provides insulation against real shocks, such as a change in the demand for exports or in the terms of trade, whereas a fixed exchange rate was desirable in the case of nominal shocks such as a shift in money demand.

The Mundell Fleming model led to two important developments in the theory of exchange rate regime choice: the impossible trinity or the trilemma; and the optimal currency area. According to the trilemma, countries can only choose two of three possible outcomes: open capital markets, monetary independence and pegged exchange rates. According to this view the gold standard flourished with open capital markets and fixed exchange rates because monetary independence was not of great importance. It collapsed in the interwar because monetary policy geared to full employment became important. Bretton Woods encompassed pegged exchange rates and monetary independence by condoning extensive capital controls. It collapsed in the face of increasing difficulty of preventing capital mobility (Obstfeld and Taylor, 1998). More recently the trilemma has led to the bipolar view that with high capital mobility the only viable exchange rate regime choice is between super hard pegs (currency unions, dollarization or currency boards) and floating; and indeed the advanced countries today either float or are part of the Economic and Monetary Union (EMU).

[2] By monetary independence, Friedman presumed that monetary authorities would follow stable monetary policies.

An optimal currency area (OCA) is defined as “a region for which it is optimal to have a single currency and a single monetary policy” (Frankel, 1999, p. 11). The concept has been used both as setting the criteria for establishing a monetary union with perfectly rigid exchange rates between the members with a common monetary policy, and the case for fixed versus floating. The criteria posed by Mundell (1961), Kenen (1969) and McKinnon (1963) for whether a region such as Europe was an OCA involved the symmetry of shocks in the member states, the degree of openness, the degree of labor mobility and the ability to make fiscal transfers.

In simplest terms, based on OCA theory, the advantages of fixed exchange rates increases with the degree of integration. Recent approaches suggest that the OCA criteria also work in an ex post sense – that joining a currency union by promoting trade and integration increases the correlation of shocks (Frankel and Rose, 2002).

2.3 Credibility and Exchange Rate Regime Choice

A different set of criteria for exchange rate regime choice than that based on the benefits of integration versus the benefits of monetary independence, is based on the concept of a nominal anchor. In an environment of high inflation, as was the case in most countries in the 1970s and 1980s, pegging to the currency of a country with low inflation was viewed as a precommitment mechanism to anchor inflationary expectations.

This argument was based on the theory developed by Barro and Gordon (1983) who discuss the case of a central bank using discretionary monetary policy to generate surprise inflation in order to reduce unemployment. They demonstrate that with rational expectations the outcome will be higher inflation but unchanged employment because the inflationary consequences of the central bank’s actions will be incorporated in workers’ wage demands. The only way to prevent such time inconsistent behavior is by instituting a precommitment mechanism or a monetary rule.

In an open economy a pegged exchange rate may promote such a precommitment device, at least as long as the political costs of breaking the peg are sufficiently large. This argument was used extensively in the 1980s to make the case for the Exchange Rate Mechanism (ERM) in Europe, and in the 1990s for currency boards and other hard pegs in transition and emerging countries.

2.4 Domestic Nominal Anchors

The case for floating has also been buttressed by the theoretical work on credibility and time consistency. Designing a set of domestic institutions that will produce low inflation and long-run expectations of low inflation is consistent with the monetary independence associated with floating rates. The creation of independent central banks (independent from financing fiscal deficits) and establishing low inflation targeting in a number of advanced countries represents a domestic precommitment strategy (Svensson, 2002).

2.5 Emerging Market Perspectives

The recent spate of emerging market crises in the 1990s has led to attention to the plight of these countries who have opened up their financial markets. Most of the countries hit by crises had pegged exchange rates. According to the trilemma view, the crises were a signal that opens capital markets, monetary independence and pegs were incompatible as had been the case with the advanced countries in Bretton Woods and the ERM in 1992. Consequently many observers have put forward the bipolar view that the only options for these countries are super hard pegs or floating.

Yet the emergers face special problems which make this simple dichotomy a bit more difficult than is posed. First in the case of hard pegs such as currency boards (or dollarization), currency crises are ruled out (to the extent the currency board is followed) but banking crises are still possible and without a monetary authority they cannot be contained (Chang and Velasco, 2001). Related to the inability to act as Lender of Last Resort is the inability to have the monetary policy flexibility to offset external real shocks. Moreover establishing a currency board or going the next step and dollarizing works best if the currency picked for the peg is of a country that has extensive trade with the emerger and has a history of monetary stability.

Second is the so called problem of "Original Sin" (Eichengreen and Hausmann, 1999). Because many emerging countries are financially underdeveloped and they may have had a history of high inflation and fiscal laxity, they are not able to either borrow in terms of their own currencies long-term or to borrow externally except in terms of foreign currencies such as the dollar. This according to Eichengreen and Hausmann, exposes them to the serious problems of both maturity and currency mismatches. In the face of a currency crisis a devaluation can lead to serious balance sheet problems, widespread bankruptcies and debt defaults. This was the case in East Asia in the 1990's and also when Argentina exited from its currency board in 2001. The "Original Sin" creates problems for emergers who float and even those who adopt hard pegs.

A third problem for emergers that float is that devaluations may have no effect on the real economy in the face of widespread indexation or a history of high inflation. Thus, there may be very high pass through from the exchange rate to the price level or in the case of original sin, as mentioned above, devaluing may actually be contractionary.[3]

[3] Although Cespedes and Velasco (2000) demonstrate that positive Mundell-Fleming aggregate demand enhancing effects may outweigh such negative balance sheet effects.

These problems suggest that intermediate arrangements may still have a role to play for such countries. Also it is important to distinguish between, on the one hand, middle and large emerging countries who have the potential and are moving in the direction of, the policies of the advanced countries and adopting domestic nominal anchors such as inflation targeting cum independent central banks; and on the other hand small very open emergers who may fare best with currency unions.

3. Measurement and Performance

In making the correct exchange rate regime choice it is very important to have some empirical evidence on economic performance. An extensive literature has developed to answer the question which regime performs best. Before discussing what the evidence seems to say however, we need to consider an important methodological question. How do we classify exchange rate regimes?

Two answers are given: either de jure or de facto. The former establishes a list of regimes like table 1 and then classifies countries by what they say they do. This is the approach that has been taken by the IMF until quite recently and authors like Ghosh et al. (2003). It is justified on the grounds that announcing a regime has important forward looking credibility effects.

The second approach by authors such as Calvo and Reinhart (2000) and Levy-Yeyati and Sturzenegger (2001) starts with the premise that for various reasons including "fear of floating" and lack of credibility, countries do not do exactly what they say they do. This approach tries to correct for this problem by using observed behavior of the exchange rate, international reserves and other variables to infer a de facto classification scheme.[4]

The most notable study using the de jure scheme is by Fischer (2001) who reports evidence of hollowing out between 1991 and 1999, the fraction of IMF members that follow intermediate regimes fell from 62% (98 countries) to 34% (63 countries). The fraction with hard pegs rose from 16% (25) to 24% (45) while the fraction that floats increased from 23% (36) to 42% (77). However, Frankel's (2002) most recent look at the data argues that more emerging countries in the past decade have opted for flexible rates than hard pegs. A similar conclusion is also reached by Larain and Velasco (2001), their table 1 shows that in 1976 86% of developing countries maintained pegged arrangements, by 1996 only 45% had some kind of peg and 52% had a flexible exchange rate arrangement.

The de facto camp doubts the meaning of these data because many peggers frequently have realignments (Obstfeld and Rogoff, 1995) referred to as "soft pegs" and many floaters are reluctant to float referred to as "hard floats" because they have "fear of floating". This is because they view devaluations as

[4] Since 1999, the IMF has also adopted a de facto classification system. See IMF (1999), chapter IV for details.

contractionary because of adverse balance sheet effects (Calvo and Reinhart, 2002). Levy-Yeyati and Sturzenegger (2000) attempt to account for these problems by constructing a de facto classification scheme based on the volatility of exchange rates and international reserves. They use cluster analysis to classify countries into the three groups of pegged, intermediate and flexible. Their evidence for the 1990s confirms the significant presence of both "soft pegs" and "hard floats." Indeed, they doubt the evidence on hollowing out – they find about equal representation in each of the three categories.

Finally, in a very recent paper, Reinhart and Rogoff (2002) construct a new "natural" classification scheme. They use a new database on dual and parallel currencies as well as chronologies of the exchange rate history for all Fund members for the past half-century, to construct a 15 category schema. They also distinguish floating by high inflation countries (freely falling) from floating by others. Like Levy-Yeyati and Sturzenegger they find extensive evidence of soft pegs and hard floats – since the 1980s over 50% of de jure floats are de facto pegs and approximately half of de jure pegs were floats.

3.1 Evidence

Table 2 presents some evidence on macroeconomic performance on inflation and real per capita growth for all the countries covered by the IMF for the past three decades. It compares some of the principal findings of the de jure and de facto classification schemes.

Panel A compares data from the Levy-Yeyati and Sturzenegger (LYS) studies with the IMF de jure classification as used by Ghosh et al. (2003) for three broad categories: floats, intermediate and pegged regimes. According to the de jure classification, floats had higher inflation rates and pegs the lowest. For LYS intermediate regimes had the highest inflation, followed by floats and pegs. Both criteria support the common wisdom and the historical evidence that pegs deliver low inflation.

With respect to real per capita growth, under the IMF classification intermediate regimes deliver the highest growth, floats the lowest. Under LYS, floats rank the highest, followed by pegs and intermediate regimes. These results likely reflect the reclassifying by LYS of countries with fear of floating as intermediate regimes, leaving mainly advanced countries in the floating category.

Panel B compares the evidence from the Reinhart Rogoff (RR) study with the IMF de jure classification scheme. RR shows five regimes. They demarcate floating into three: freely floating, freely falling (defined as countries with high inflation rates and depreciation rates above 40%) and managed floating. Pegs represent hard pegs and limited flexibility characterizes all the rest. RR's de facto results are very different from the de jure ones and from LYS. Because they strip out freely falling from floating they pick up the good inflation performance of the high-income countries seen in chart 1. Also hard pegs do not appear to be a panacea against inflation. Finally growth performance is by far the best for the freely floaters, a result similar to LYS.

The de facto evidence on performance is markedly different from the de jure evidence from the IMF. The fact that both LYS and RR using very different methodologies associate floating with high growth and that floating is not associated with the high inflation seen in the de jure classification suggests that how regime classification is done has important implications for the issue of regime choice.[5] [6]

Table 2: De Jure versus De Facto Exchange Rate Classification

Panel A: Levy-Yeyati and Sturzenegger (2000, 2001), 1974–1999 (Annual) 154 Countries

	Inflation			**Real per Capita Growth**		
	Float	Intermediate	Peg	Float	Intermediate	Peg
IMF	22.3	20.2	16.7	1	2	1.2
LYS	14.2	38.3	9.7	1.9	0.8	1.5

Panel B: Reinhart and Rogoff (2002), 1970–2001 (Annual) 153 Countries

			Inflation					**Real per Capita Growth**		
	Free Float	Freely Falling	Managed Float	Limited Float	Peg	Free Float	Freely Falling	Managed Float	Limited Float	Peg
IMF	174	n. a.	74.8	5.7	38.8	0.5	n. a.	1.9	2.2	1.4
RR	9.4	443.3	16.5	10.1	15.9	2.3	–2.4	1.6	2.4	1.9

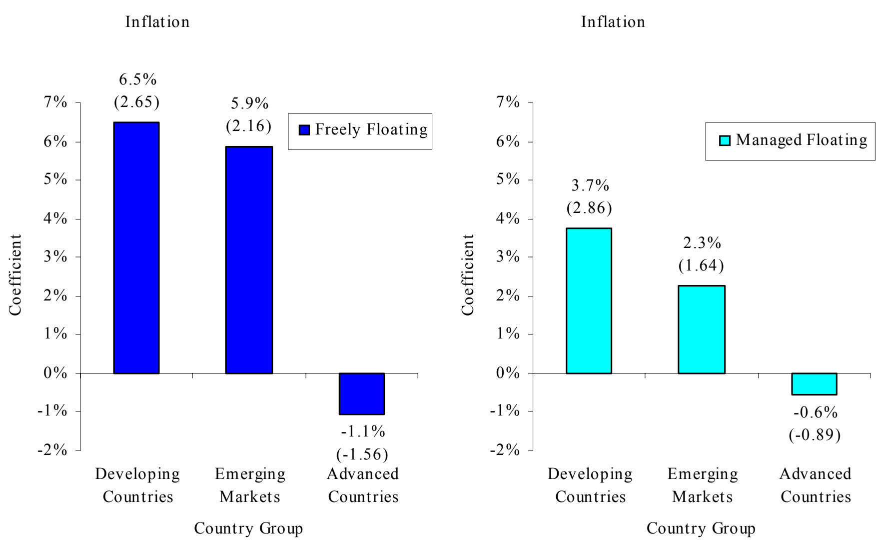
[5] Ghosh et al. (2002) using the de jure definitions find from regressions of inflation on exchange rate regime dummies and other variables such as money growth, openness, terms of trade shocks that the differences between pegged and floaters narrows considerably. For real per capita growth they cannot detect any significant differences across regimes.

[6] Juhn and Mauro (2002) using both the de jure and LYS de facto classification schemes and a large panel data set from 1990 to the present, find that no robust empirical regularities can be found to explain exchange rate regime choice. Whereas Levy-Yeyati, Sturzenegger and Regio (2002) using the LYS classification scheme and panel data (demarcated into industrial and emerging countries) from 1974 to the present, find that exchange rate regime choice for industrial countries is explained by OCA type variables, while for the emergers balance sheet effects and the capital account are important.

A recent IMF Board paper (Rogoff et al., 2003) extensively reviewed the costs and benefits of both approaches and the relative merits of the different de facto empirical schemes. The paper then extends Reinhart and Rogoff's natural classification to the exchange rate experiences of all IMF members divided into the following categories: developing countries with limited capital market access; emerging market countries with access to international capital markets and advanced countries.

They find that macro performance across regimes varies dramatically between these three groups. Chart 1 displays the salient evidence. Panels A and B show the evidence on inflation. It is based on regression analysis of exchange rate regime dummies on inflation conditional on a number of variables including money growth. The chart clearly shows that developing countries benefit from adhering to pegged arrangements; for emergers inflation rises with flexibility possibly explaining their "fear of floating", while for advanced countries flexible rates deliver the lowest inflation.

Chart 1a: Performance of Floating Regimes Relative to Pegs

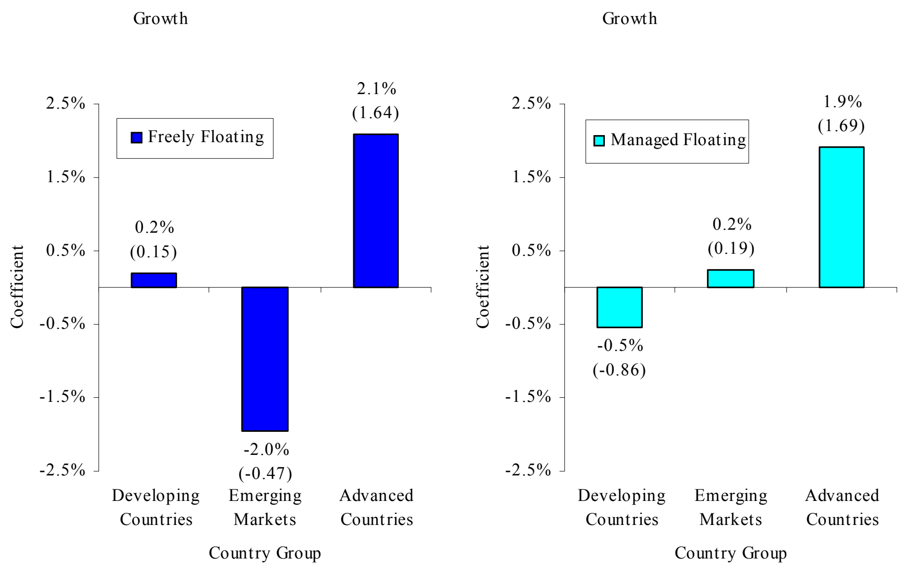


Note: Figures in parentheses are t-statistics. The bars depict differences in performance relative to pegged exchange rate regimes, conditioning on a range of other variables.

Source: Rogoff et al. (2003).

Chart 1b presents the evidence on the real per capita growth. It shows that developing countries perform best with pegged regimes, advanced countries do best with floating; and the emerging countries are in between.

Chart 1b: Performance of Floating Regimes Relative to Pegs



Note: Figures in parentheses are t-statistics. The bars depict differences in performance relative to pegged exchange rate regimes, conditioning on a range of other variables.

Source: Rogoff et al. (2003).

The evidence highlights the beneficial influence of flexible regimes as countries become more advanced. This may reflect the views that floating permits more rapid adjustment following shocks and that with more mature financial sectors advanced countries are not subject to the offsetting balance sheet risk of floating. I develop these themes below in a historical context.

4. History of Exchange Rate Regime Choice

Exchange rate regime choice has evolved considerably in the past century. Table 3 shows a very rough chronology of the exchange rate regimes the world has seen since 1880. They have expanded considerably from the simple choice between the gold standard and fiat to the 15 regimes demarcated by Reinhart and Rogoff. Yet the basic choice between fixed and flexible still remains at the heart of the matter.

Table 3: Chronology of Exchange Rate Regimes 1880–2000

1880–1914	Specie: gold standard (bimetallism, silver), currency unions, currency boards, floats
1919–1945	Gold exchange standard, floats, managed floats, currency unions (arrangements); pure floats, managed floats
1946–1971	Bretton Woods adjustable peg; floats (Canada); dual/multiple exchange rates
1973–2000	Free float, managed float, adjustable pegs, crawling pegs, basket pegs, target zones or bands; fixed exchange rates, currency unions, currency boards

My approach in this section is not to repeat the history of international monetary regimes which is well covered by Eichengreen (1996) and Bordo and Schwartz (1999) but to focus on a comparison of monetary regimes in the two eras of financial globalization, 1880–1914 and the present. Such a comparison highlights two key issues of relevance for today: a) the different choices facing advanced and facing emerging countries; b) the role of financial integration. In what follows, I examine the experience of the advanced (core) countries and the emerging (periphery) countries in historical perspective.

The core countries of the pre 1914 era: Great Britain, France, the Netherlands, Germany and the U.S.A. as well as a number of smaller western European countries and the British Dominions adhered to the classical gold standard. The gold standard by 1880 had evolved from the historic specie regime based on bimetallism. An extensive historiography covering this evolution emphasizes factors such as accidents of history: the Franco Prussian War and massive silver discoveries in the U.S.A., attempts to follow the example of the leading commercial nation Great Britain, which had been on a de facto gold standard since 1717; network externalities and the technology of coinage.

The essence of the classical gold standard for the core countries was a credible commitment to maintain gold convertibility i.e. following the gold standard rule. Adhering to gold convertibility can be viewed as a commitment mechanism to the pursuit of sound monetary and fiscal policies (Bordo and Kydland, 1996). The commitment by these countries to gold convertibility was credible based on their past performance. Moreover, the gold standard rule was embedded in a long history of financial development. This includes the creation and successful servicing of public debt, by the Dutch and the British in the 17th and 18th century, the founding of central banks such as the Bank of England in 1694, and the development of stock markets, banking systems, and non bank financial intermediaries in the 18th and 19th century (Rousseau and Sylla, 2003).

The rule followed was a contingent rule: adhere to gold parity except in the event of a well understood emergency such as a financial crisis or a war. Under such circumstances a temporary departure from parity was tolerated on the understanding that it would be restored once the emergency had passed. Because these countries demonstrated their willingness to follow such a rule e.g. the British experience in the Napoleonic war and the U.S. in the Civil War, and to subsume domestic policy goals to the external constraint, they had earned the credibility to have a measure of short-term policy flexibility that enabled them to buffer transitory shocks. Indeed temporary departures from gold parity would be offset by stabilizing short-term capital flows.

Moreover, the gold points can be viewed as a modern credible "target zone" a la Krugman (1991) which allowed the monetary authorities some flexibility ,for example, to conduct expansionary monetary policy to lower short-term interest rates and thus compensate for declining output. The decline in short-term interest rates would be offset by a rise in the exchange rate on the expectation that the parity would be restored (Bordo and MacDonald, 2004).

Today, the advanced countries (with the principal exception of the European Union) have floating exchange rates. To a certain extent, the current trend towards floating has some resemblance to the classical gold standard in which the fluctuation margins have been widened to give more flexibility. The key difference between then and now is that the nominal anchor gold parity around which the target zone is operated has been jettisoned and a domestic fiat nominal anchor has been substituted in its place, which allows exchange rate flexibility without the constraint of a target zone. The two systems are similar in spirit because they are each based on credibility. They also had independent central banks, minimal regulation of the financial system and the absence of capital controls.

In this sense, the evolution from the gold standard to today's managed floating represents a major technical improvement. Today's regime has adopted the credibility or what Bordo and Schwartz (1999) call the "convertibility principle" of the classical gold standard without the high resource costs and the "vagaries" of the gold market which plagued the classical gold standard. Also, the development of deep and liquid foreign exchange and other financial markets have aided the smooth operation of a floating rate system.

A consequence of this analysis is that logically, the pre 1914 core countries that had developed strong money and financial markets and institutions before World War I ought to have floated – something which they did not. The possible reasons why the logic of the target zone was not pushed further include: the protection that gold gave to bond holders against inflation risk and the political constituency thus created; and the path dependency of gold as money.

4.1 Middle Years: 1914–1972

What happened in the middle years of financial deglobalization between 1914 and 1973? According to the trilemma view of Obstfeld and Taylor (2002), the gold standard with free capital mobility had to be jettisoned in the advanced countries in the face of growing demands by an expanding electorate and organized labor to stabilize the business cycle. More likely it was abandoned because of the shocks and imbalances caused by World War I.

The gold standard was reinstated as a gold exchange standard in 1925. Central banks supplemented their gold reserves with foreign exchange (sterling and dollar). The gold exchange standard collapsed in 1931. Its brief life is attributed to a number of fatal flaws in its design (see Bordo, 1993) and to a decline in credibility reflecting the fact that consequent upon the growth of democracy monetary authorities had the domestic goal of full employment to satisfy as well as to maintain gold convertibility (Eichengreen, 1992)

The result was capital controls in the 1930s and the adjustable peg in the Bretton Woods era after World War II. In the late 1960s, the latter was blown apart, leading to the current floating regime. The demise of the Bretton Woods was precipitated by the pursuit of financial policies inconsistent with maintaining the pegged rate system by the key countries, especially the U.S., which had used expansionary monetary and fiscal policies to finance the Vietnam War; as well as by the pressure of international financial integration in spite of the capital controls (Bordo, 1993).

4.2 Core versus Periphery: History of the Periphery

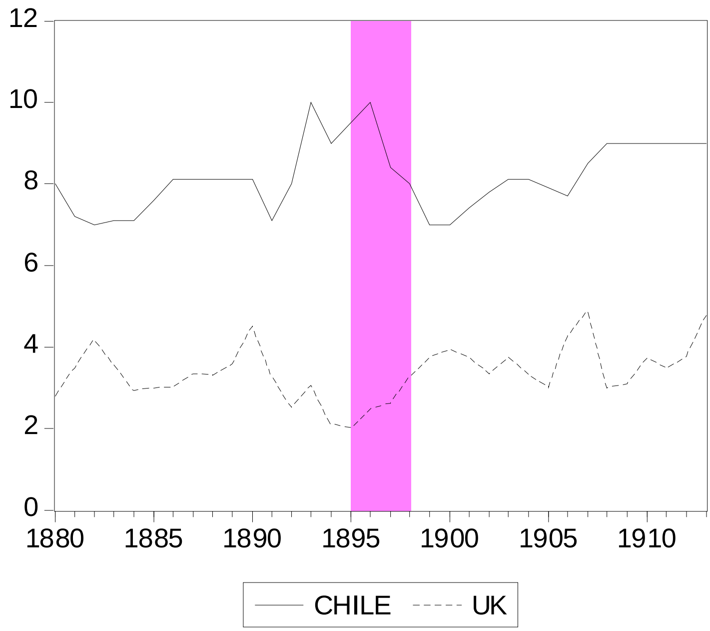
The periphery countries faced a vastly different exchange rate experience from the core countries in the pre 1914 era of globalization as they have in the recent era. Pre 1914 in contrast to the core countries, many peripheral countries did not develop the fiscal and monetary institutions that allowed then to credibly follow the gold standard rule. Because they lacked credibility they were not buffered from shocks by the "target zone".

In an advanced country, a shock leading to a depreciating exchange rate could temporarily be offset by lowering interest rates so that output may recover. For the periphery, exchange rate depreciation could trigger capital flight and financial distress. This could occur because the markets do not expect that the exchange rate will be restored by future corrective policies. It also could occur because a substantial amount of external debt is denominated in a foreign currency.

Because of this problem, floating did not create much room for the periphery countries to conduct active monetary policies compared to the experience of the core countries. But going onto gold did not buy immediate credibility for them either as illustrated by the levels of short-term interest rates in a number of typical members of the periphery.

Charts 2a to 2e show that the weaker members of the gold club faced higher short-term interest rates *even when on gold* than is consistent with their actual exchange rate record. This suggests some kind of "peso" problem. The high short-term rates faced by Chile, Greece, Portugal, Italy or Russia, during their more or less extended flirt with gold suggests that problems that the modern periphery has with pegging, as evidenced in the emerging financial crises of the 1990s, have 19th century precedents. The fact that even when on gold, these countries could face high short-term rates, might explain why some of them ended up floating.

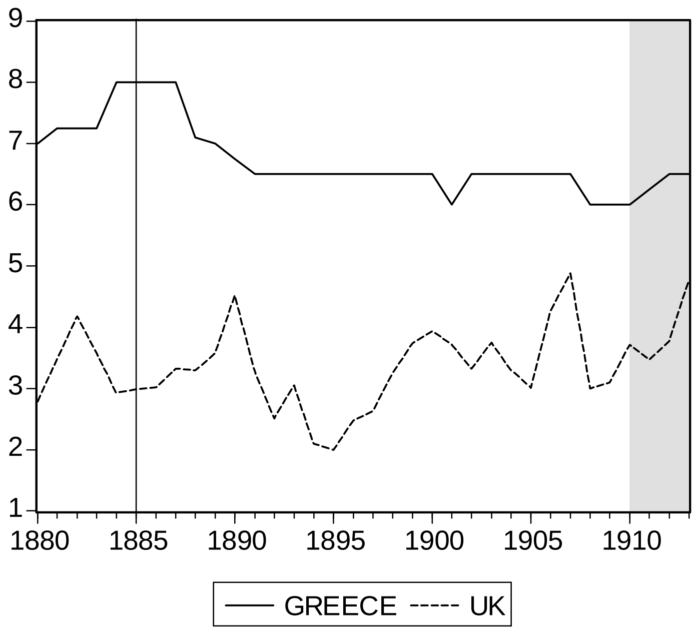
Chart 2a: Short-Term Interest Rates (Bank Rates), Chile (Compared to U.K.) 1880–1913



Note: Shaded area represents the period when Chile was on the gold standard.

Source: Bordo and Flandreau (2003).

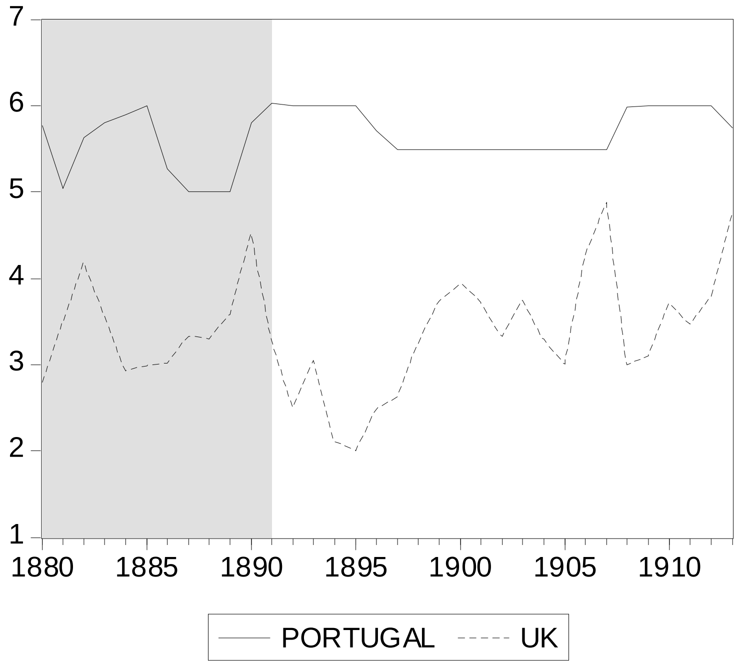
Chart 2b: Short-Term Interest Rates (Bank Rates), Greece (Compared to U.K.) 1880–1913



Note: Shaded area represents the period when Greece was on the Gold Standard (December 1884 – July 1885).

Source: Bordo and Flandreau (2003).

Chart 2c: Short-Term Interest Rates (Bank Rates), Portugal (Compared to U.K.) 1880–1913



Note: Shaded area represents the period when Portugal was on the gold standard.

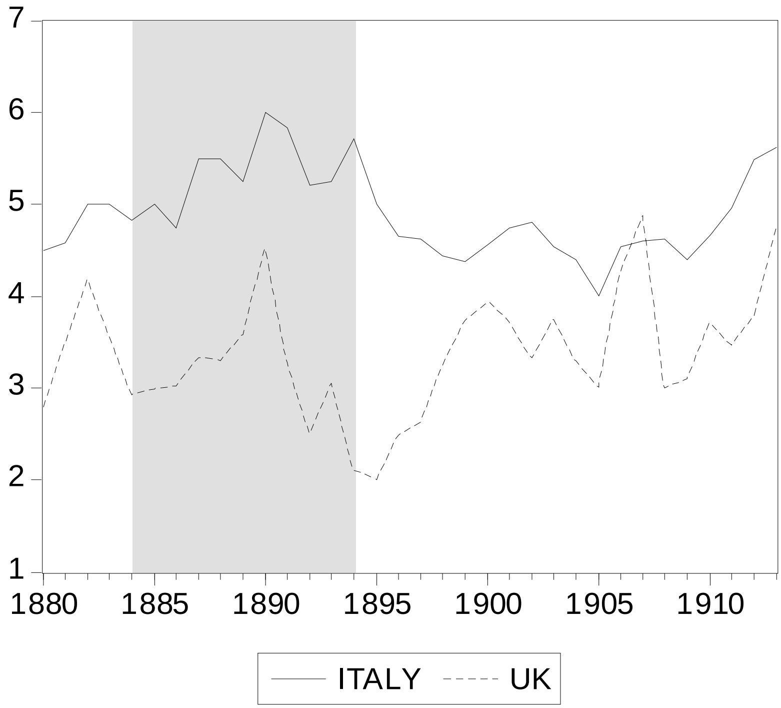
Source: See Bordo and Flandreau (2003).

Chart 2d: Short-Term Interest Rates (Bank Rates), Russia (Compared to U.K.) 1880–1913

Note: Shaded area represents the period when Russia was on the gold standard.

Source: Bordo and Flandreau (2003).

Chart 2e: Short-Term Interest Rates (Bank Rates), Italy (Compared to U.K.) 1880–1913



Note: Shaded area represents the period when Italy was on the gold standard.

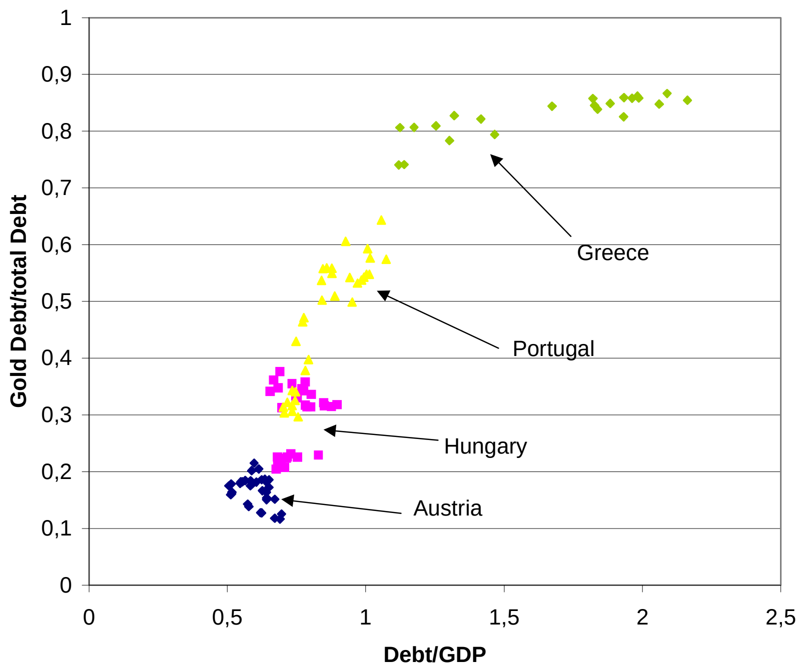
Source: Bordo and Flandreau (2003).

4.3 Fear of Floating, 19th Century Style: A New View of the Gold Standard

The modern "fear of floating" problem whereby countries which say they float do not, for the reasons mentioned above discussed by Calvo and Reinhart (2002) seem to have been prevalent pre 1914. If fixing was quite painful under the gold standard for many of the peripheral countries, floating could be just as problematic for them as is the case today. This was due to pervasive problems of currency mismatch arising from the inability for underdeveloped borrowing countries to issue foreign debt in their own currencies. This problem which prevails today Barry Eichengreen and Ricardo Hausmann (1999) refer to as “Original Sin”. The bonds of peripheral countries pre 1914 borrowing in London, Paris or Amsterdam would always contain clauses tying them in gold to the currency of the country where the bond was issued – “the gold clauses”.

This practice may have been the solution to a commitment problem. While local issues could be easily inflated away, foreign issues with gold clauses provided safeguards, precisely because they in turn induced governments to be on their guard. See chart 3 which shows that the share of gold debt was an increasing function of total indebtedness for a number of peripheral countries.

Chart 3: Total Indebtedness and Currency Mismatch: Austria, Hungary, Portugal, Greece 1880–1913



Source: Crédit Lyonnais Archives.

Moreover adhering to the gold standard was not a perfect substitute for the gold clauses. Since the club of countries that could issue debt abroad denominated in their own currency was much narrower than the set of countries on the gold standard (Bordo and Flandreau, 2003). Table 3 contains a list of "senior" sovereigns in London from Burdett's Official Stock Exchange Intelligence. The countries whose bonds were listed in terms of their own currencies were: the U.K., U.S.A., France, Germany, Belgium, Netherlands, Switzerland ad Denmark.

The inability to assume debt in their own currency meant that having a large gold debt and experiencing an exchange rate crisis could have devastating consequences when a country embarked on a spending spree and public debt increased. The share of gold denominated debt increased in turn. This created an explosive mismatch.

The crises of the 1890s very much like those of the 1990s provided evidence of the mechanism at work. The crises started with Argentina where the expansion of the gold debt, accompanied by paper money issue, pushed the level of the debt burden to unsustainable heights. Public debt crises in Portugal and Greece (1892 and 1893) both resulted from the depreciation of the exchange rate that had brought these countries public debts to unsustainable levels.

The responses to these problems induced by high debts and financial vulnerability were also surprisingly modern. Some countries such as Spain and Portugal continued to float but minimized their exposure by limiting their borrowings abroad. Some others such as Russia or Greece developed de facto currency boards. They accumulated gold reserves beyond what was statutorily necessary and in effect adopted gold cover ratios that were consistently above 100%. Yesterday like today there seems to have been a hollowing out as a response to financial crises.

Clearly, in view of the narrow list of countries that were able to float debts in their own currency, much of the emerging world was bound to face currency mismatches. From this point of view, gold adherence became for those willing to protect themselves against international financial disturbances a second best solution. It is not that a gold standard immediately brought credibility. Rather it served as an insurance mechanism and in this sense fostered globalization. In other words the spread of the gold standard in the periphery may have been an endogenous response to the gold clauses: as soon as the price of this insurance decreased (as was the case during the gold inflation of 1897-1914), the gold standard expanded, as more and more countries found it less dangerous to borrow with gold clauses since the risk of being tipped off gold declined.

The interpretation of the seemingly opposite nature of global exchange rate regimes in the two big eras of globalization (fixed exchange rates back then, floating ones today) has put at the center of the picture the role of financial vulnerability and financial crises. To some extent, the Baring crises yesterday played a role similar to the crises of the late 1990s in reminding emerging floaters about the dangers of an impervious floating exchange rate. As a result while developed countries have always had the temptation and the ability to float (with floating restricted yesterday by path dependency and the difficulty of creating domestic institutions that could create a domestic nominal anchor) the periphery has always faced serious difficulties in floating, viewing the gold standard yesterday, and hard pegs today as a second best solution.

Bordo and Flandreau (2003) present econometric evidence for the pre 1914 and the 1973 eras linking the dominant regime followed the gold standard pre 1914, floating today, to financial maturity (defined as open and deep financial markets, stable money and fiscal probity) which they proxy by financial depth, measured as the ratio of broad money to GDP. Before 1914 when the gold standard was the dominant regime they find that countries adhering to gold to have greater financial depth than those that did not post 1976, when floating was the dominant regime. They found, in general, that countries that could successfully operate pure floats were more financially developed than those which could not.[7]

The key distinction for exchange rate regime choice between core and periphery then; advanced and emerging now; is financial maturity. It is manifested in open and deep financial markets, stable money and fiscal probity. It is evident in the ability to issue international securities denominated in domestic currency or the absence of "Original Sin". Indeed, countries that are financially developed, in a world of open capital markets should be able to float as advanced countries do today, just as they successfully adhered to gold before 1914.

Evidence for the core countries that the classical gold standard operated as a target zone with the gold points serving as bands in which credible floating could occur and external shocks be buffered is a presage to the regime followed today. Today's floating is a product of financial maturity and the development of the technological and institutional structures and constraints that allow policy makers to follow stable money and fiscal policy without adhering to an external nominal anchor.

Thus, the dynamics of the international monetary system and evolution of the exchange rate regime is driven by financial development and international financial integration. Financial crises such as those of the 1890s and 1990s are the defining moments that reveal the regime fault lines between advanced and emerging countries. The evolution of the gold standard and the movement towards successful floating by advanced countries today required achieving financial maturity. The same will be required for the rest of the world. In the interim intermediate arrangements including impediments to free capital movements will prevail. Financial crises as occurred in the 1890s and the 1990s will also continue to be an important part of the process of regime evolution as an ultimate structuring force.

5. Policy Implications

Which exchange rate arrangement is best? This survey historically agrees with Frankel (1999) who states that "no single currency regime in best for all countries and that even for a given country it may be that no single currency regime is best for all time." However, the world is evolving towards a floating exchange rate regime which is the regime of the advanced countries which in many ways echoes the movement towards the gold standard a century ago. The principal exception to

[7] With the exception of small economies with considerable openness or close trading links to a large country who chose not to float and instead adhered to hard pegs e.g. Hong Kong.

the pattern seems to be currency unions such as EMU which the European countries have joined (largely for political reasons) as have a number of small very open economies.

However, although the world is evolving toward floating, intermediate regimes still represent a large fraction of all arrangements. Is there still a case for them? The principal case against them of course was the disastrous experience with the adjustable peg under the Bretton Woods system which collapsed under speculative attacks and the recent Asian crises which involved largely crawling peg arrangements.

In reaction to that experience, many observers have made the case for bipolarity. Moreover the "fear of floating" view has made the case that emergers should likely move toward hard pegs rather than floats. Yet, both currency boards and dollarization have serious flaws, the principal of which is the absence of a monetary authority to act as a lender of last resort or to offset external shocks (Larain and Velasco, 2001). Moreover, currency unions which can overcome those problems need considerable political will to survive in the face of the shocks that inevitably come along (Bordo and Jonung, 2000).

Thus in the face of these considerations the case still can be made for intermediate arrangements for emerging countries which are not yet sufficiently financially mature to float. One such arrangement that seems to be a promising path that countries could take on their journey towards floating is Morris Goldstein's (2002) "Managed Floating Plus" scheme.[8] It supplements the inflation targeting cum independent central bank approach that several advanced countries (U.K., Sweden, New Zealand and Canada) follow, with exchange market intervention to offset temporary shocks, a comprehensive reporting system to maintain the level and foreign currency exposures of external debt and perhaps a sequential strategy to the opening up of domestic financial markets to external capital flows. Finally, there is still a case for monetary unions for countries that are closely politically and economically integrated or very small open economies.

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[8] For an interesting discussion of this and other options see Baillu and Murray (2002).

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Regional Monetary Arrangements – Are Currency Unions the Way Forward?

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1. Introduction[1]

After the international financial crises of recent years the debate on the appropriate exchange rate regime has again intensified. Pegged exchange rates were often seen as a major cause of the respective crisis. Since then it has been popular to argue that a hollowing out of the middle of the exchange rate regime choice has occurred. This essentially means that only hard pegs, like currency boards, or independent floats are viable regimes among the continuum of exchange rate regimes. All the middle regimes such as soft pegs or managed floats are argued to be either unsustainable and/or too crisis-prone because they lack credibility and are vulnerable to speculative attacks.

While the Optimal Currency Area (OCA) literature still offers a valid framework for analyzing the choice of an exchange rate regime, in the recent literature on exchange rate regime choice, the concept of *fear of floating* (Calvo and Reinhart, 2002) has become popular. Fear of floating rests on the assumption that highly volatile exchange rates limit gains from trade, increase risk premia on interest rates and lower welfare. While d*e jure* classified as floating exchange rates, these *de facto* exchange rate pegs involve high risks as evidenced by the financial crises in emerging market countries (EMCs) over the past decade.

This paper will briefly review the sequencing of economic integration, highlight some aspects of the optimal currency area literature, look at the steps taken in the European Union as well as the new EU member states and will after looking at the current regional integration processes in Latin America and Asia, draw some

[1] Helpful comments by Eduard Hochreiter (OeNB) and Franz Nauschnigg (OeNB) and an anonymous referee are gratefully acknowledged. The usual caveats apply.

conclusion for other regions in the world. The European experience offers some valuable lessons, despite the differing macroeconomic challenges that European countries faced in the 1980s compared to the challenges Latin America or Asia are confronted with today. These principally suggest that it will take time before these regions will meet the criteria necessary to successfully start a currency union and proposes that as an initial step inflation targeting possibly accompanied by some fiscal rule may be a suitable and viable foundation for fostering macroeconomic stability. This stability coupled with stronger institutions and a certain policy convergence could help in the long-run towards achieving the aim of a currency union.

2. Steps of Integration

Monetary arrangements have a lot to do with the degree of economic integration. But there are no straightforward 'laws' about the degree and depth of regional (economic) integration in the global political economy. Bela Balassa (1962) set out a logical roadmap which places a regional monetary arrangement in the context of regional economic integration. First, countries decide to create a free trade area. This could then lead to a common external tariff, thereby producing a *de facto* customs union. Efficiencies would be further generated by the formation of a genuine internal market amongst member countries. The gains of the internal market could be best achieved through further *deepening* of integration. Therefore, monetary integration – the use of a common currency – would be the next stage. This in turn would generate incentives for further political integration.

A second issue follows from the obvious conclusion of Balassa's work: at what point does the management of economic integration require political integration? At the very least, some pooling of economic sovereignty seems required, and the development of some sort of region-level regulatory authority would seem rational in the circumstances. This does not imply that a new political entity has to be formed. And whether all forms of integration such as customs unions, common markets and monetary unions must have similar levels of institutionalization remains an open question as well.

The Balassa sequencing however, does not set out a roadmap which exchange rate regime to adopt to accompany regional integration efforts. European countries, before joining the Economic and Monetary Union (EMU) mostly chose to explicitly or implicitly use the DM as an exchange rate anchor. Today, the new EU member states follow different regimes ranging from currency boards such as in Estonia to free float such as in Poland. Provided macroeconomic policy consistency, any exchange rate regime is therefore conceivable with regional integration short of a monetary union.

3. Choosing an Exchange Rate Regime

After the Mexican (1994), the Asian (1997–98), the Russian (1998), the Brazilian (1998-99), the Turkish (2000) and the Argentine (2001) financial crises, the debate on the appropriate exchange rate regime has intensified. This is owing to the fact that pegged exchange rates were very often the root and/or cause of the respective crisis. Since then it has been popular to argue that a hollowing out of the middle of the exchange rate regime spectrum has occurred. This essentially means that only hard pegs and independent floats are viable regimes among the continuum of exchange rate regimes. All the middle regimes such as soft pegs or managed floats are argued to be either unsustainable and/or too crisis-prone because they lack credibility and are vulnerable to speculative attacks.

However, the hollowing-out followers soon went back to the impossible trinity. Fischer (2001) or Mussa et al. (2000) recognize that managed floating and other middle regimes are viable for many countries with certain conditions of capital mobility and economic development. Interior solutions then turn out to be the best for many (small) countries with low capital mobility, underdeveloped capital and foreign exchange markets and diversified trade structures.

The choice of an exchange rate regime depends on several factors. As analytical tools two theories have been advanced that may guide policy-makers and economists alike.

3.1 Optimal Currency Criteria

The classical theory of Optimum Currency Areas (OCA) developed by Mundell, McKinnon and Kenen, defines an optimum currency area as a geographical region in which member countries should use absolutely fixed exchange rates or have a common currency. Mundell and his followers stipulated several criteria to assess whether a country should belong to an optimal currency area. These criteria include the symmetry of external shocks, the degree of labour mobility, the degree of openness; and the extent of economic diversification. The more recent literature uses the same criteria to assess whether a country should fix or float its currency against currencies of countries in a specific optimal currency area. For example, if a country is relatively open in terms of trade to another or a currency bloc, but has no significant labour mobility, its economy is not well diversified, and it faces asymmetric shocks, a flexible exchange rate is likely to be a better choice for that country.

The intuition behind the optimum currency area criteria is that the real adjustment within an economy that has been hit by external shocks, usually takes time if nominal rigidities exist. The absence of labor mobility across borders rules out another adjustment mechanism. Thus, a flexible exchange rate would be the only automatic shock absorber that the country may rely on. Although, Mundell did not discuss directly the other benefits of using fixed exchange rates such as minimizing transaction costs in trade (see below), he implied that if the cost of adjustment for a country is not large, i.e. if the OCA criteria are met to some extent, it is better to choose a fixed exchange rate in order to get the benefit from the stability of the currency.

A more recent literature discusses another benefit of flexible exchange rates relying on the doctrine of the *impossible trinity*, which simply means the impossibility of having a fixed exchange rate, capital mobility and monetary independence at the same time (Frankel, 1999). Under this doctrine, having a flexible exchange rate under the condition of high international capital mobility allows policy makers to conduct an independent monetary policy for domestic purposes. But if domestic authorities cannot make good use of the independence of monetary policies, it may be better to surrender this independence in order to import stability from other countries. Furthermore, other factors such as central bank independence, administrative capacity, depth and liquidity of foreign exchange markets can also influence the trade-off between monetary independence and exchange rate stability.

Theoretical models that try to formalize these ideas (e.g. Bayoumi, 1994, Calvo 1999) generally confirm the intuition from the OCA and the impossible trinity literature. However, very often they have to use simplified assumptions and thus the results may be of limited usefulness when policy makers have to choose an exchange rate regime. And as Cohen (2000) put it "for every one of the characteristics conventionally stressed in OCA theory, there are contradictory historical examples – cases that conform to the expectations suggested by OCA theory and others that do not. None seems sufficient to explain observed outcomes. This is not to suggest that economic factors are therefore unimportant. Clearly they do matter insofar as they tend, through their impact on economic welfare, either to ease or exacerbate the challenge of sustaining a common currency. But equally clearly, more has gone on in each case than can be accounted for by such variables alone."

Exogeneity or endogeneity of OCA criteria has also been in debate. Frankel and Rose (1998) argued that some criteria such as the synchronization of business cycles or trade relationships are endogenous. If this is true, an exchange rate peg and a common monetary policy can be self-validating such that countries pegging or fixing to another currency or joining a currency union will move closer to meet the OCA criteria by increasing intra-industry trade and correlating business cycles more closely.

Nevertheless, OCA criteria do matter if a country decides to tie its currency to an anchor, which may turn out to be an unsuitable one. In order to combat a history of hyperinflation and to constrain profligate economic policies, Argentina chose a currency board by tying its currency to the U.S. Dollar. However, the U.S. Dollar was the non-dominant anchor and without supporting fiscal policies by Argentina coupled with weak institutions, this decision proved disastrous given the weak trade links and business cycles which were out of step with the anchor. This then lead to increased debt, lower investment and lower growth. Endogeneity, therefore, should not be taken for granted to work its magic if the political willingness to subordinate domestic policy objectives does not exist to maintain the currency peg and if the institutions are not in place to support such an exchange rate regime.

3.2 Fear of Floating

The second concept, which has become popular in the recent literature on exchange rate regime choice, has been coined *fear of floating* (Calvo and Reinhart, 2002). There are two main explanations for the fear of floating hypothesis. First, exchange rate variability is one of the most prominent features of open economy macroeconomics and the tendency for nominal exchange rates to move so volatile and unpredictably has been blamed for limiting gains from trade and for lowering welfare. A desire to moderate this volatility has been a motivation behind the managed or fixed exchange rate regimes of many countries. Whether or not a particular exchange rate regime has a significant impact on trade is still contested; empirical evidence points both ways if an effect is seen at all. Nevertheless, there is a widespread belief that exchange rate stability would significantly promote trade in particular for members of a currency union (Rose, 2000). Therefore, it is argued that the use of a fixed exchange rate helps emerging market countries to promote growth through high investment and saving.

The second explanation is euro-/dollarization of liabilities. Since most developing countries cannot borrow overseas in their own currencies[2], most of their foreign liabilities are denominated in one of the major foreign currencies. Therefore, a sharp depreciation of their exchange rates would put severe pressure on the balance sheet of the financial and the corporate sector (Williamson 2000). Pegging the exchange rate to an anchor currency thus serves as an informal forward hedge, because of the huge flow of short-term dollar payments coming due, it is too risky to let the exchange rate move randomly.

For most EMCs the IMF advocates more flexible exchange rate regimes or at least advocates to choose an exit strategy if they have adopted an intermediate regime. Recent literature (Rogoff et al., 2003) finds that the advantages of exchange rate flexibility increases as a country becomes more integrated into global capital markets and develops a sound financial system. Rogoff et al. find that free floats have, on average, registered faster growth than other regimes in advanced economies without incurring higher inflation. Developing countries with limited access to private external capital, pegs and other limited-flexibility arrangements have been associated with lower inflation, without an apparent cost

[2] This has been coined the *original sin problem*.

in terms of lower growth or higher growth volatility. However, in EMCs with higher exposure to international capital flows, the more rigid regimes have had a higher incidence of crises.

The usefulness of flexible exchange rates as shock absorbers depends largely on the types of shocks hitting the economy and the exchange rate. Flexible exchange rates can generate rapid adjustment in international relative prices even when domestic prices adjust slowly. This makes them potentially useful absorbers of real shocks, which require an adjustment in relative prices in order to *switch expenditure* and cause output losses or overheating in the absence of price adjustment. A sudden drop in demand would, under flexible exchange rates, cause depreciation which crowds in extra demand.

On the other hand, the exchange rate adjustment in response to monetary and financial shocks leads to undesired changes in relative prices. In the case of a negative financial shock that puts upward pressures on interest rates, the exchange rate would appreciate, amplifying rather than dampening the negative impact on output. Under fixed exchange rates, in contrast, such a shock would be neutralized by an increase in liquidity stemming from a balance of payments surplus. Such asymmetric shocks would not occur in a currency union (Buiter and Grafe, 2002). Thus, the usefulness of flexible exchange rates declines as the relative importance of asymmetric monetary/financial shocks increases. If exchange rate changes do not generate an adjustment in international relative prices because pass-through to import prices is very small, the exchange rate is of little use as a shock absorber even in the case of asymmetric real shocks, though the empirical evidence remains supportive of the ability of the exchange rate to affect relative prices (Obstfeld, 2002).

If the two corner hypothesis is taken for granted, *in fine* many countries should choose to permanently lock in their exchange rates through currency boards or dollarization/euroization. Given the political unpalatability of dollarization/euroization along with significant policy constrictions which also afflicts currency boards, a currency union seems to be left as a practicable alternative. As will be further explored below, monetary unions are a serious long-term proposition for many regions but appear to be unfeasible in the short- to medium-run largely owing to political problems. Therefore, more flexible or intermediate regimes with less emphasis on the exchange rate as a policy target can be stable provided that the exchange rate and domestic economic macroeconomic polices are determined in a mutually consistent manner.

4. European Experience

The Economic and Monetary Union (EMU) was a logical continuation of the Balassa sequencing: political sovereignty and economic interdependence often are in conflict. This conflict was resolved by creating a new supranational authority in the monetary and exchange rate domain. Problems and conflicts arise among states that, on the one hand, retain control of their national currencies and are able to pursue different monetary and exchange-rate policies and, on the other, have economies that are not only highly interdependent but are being reconstituted into a single internal market. Since economic interdependence was the objective, one remedy when policies conflict and either impose costs on others or impede the development and maintenance of the single market (or both), is to increase the congruence between the scope of political authority and the domain of economic activity. For states that are embedded in a densely institutionalized supranational organization, that in all likelihood means extending the domain of responsibility and institutional capacity of that organization.

This approach has remained largely unchanged since it was first implemented in the late 1960s. It is predicated on the assumptions that attainment of an internal market among the member-states requires stability among the currencies of the member-states, that currency instability can be eliminated by irrevocably fixing the exchange rates among the member-states' currencies, and that maintaining irrevocably fixed exchange rates permanently requires the creation of a common currency and an institution at the supranational level charged with conducting monetary policy.

The move towards monetary union in Europe involved several steps and was very often driven by political considerations. The Economic Community of Six agreed to eliminate all internal tariffs and to establish the first phase of common agricultural prices by July 1, 1968 (the Werner Plan). This reduced the ability of governments to affect, to their advantage, the prices of foreign-produced goods in domestic markets and thus would have made relative prices, and trade, dependent exclusively on costs, profits and exchange rates. Common prices of commodities would also require stable exchange rates since countries were highly sensitive to, and concerned about dampening fluctuations over time in the value of their currencies.

The Single European Act explicitly put EMU back on the agenda of the Community. An important decision was taken in June 1988 to remove all exchange controls that impeded the movement of capital by mid-1990. It created the possibility that capital could, in response to divergent economic performances, move across borders without restrictions. The result of that free movement was that central banks lost much of their ability to control exchange rates, possibly leading to greater variability of currencies, amplifying and exacerbating the volatility of exchange rates. The expected increased volatility of exchange rates was a serious threat to the internal market. The creation of Monetary Union and the European Central Bank enabled members to resolve these tensions and step down further on the road of integration.

The agreement to commence with Economic and Monetary Union can be explained politically by the commitment of member states to the ongoing process of European integration driven by France and Germany; by the recognition that the process of integration had acquired a life and a history of its own covering over 50 years and that individual governments were bound by the commitments of their predecessors; that none of the Member States wished to be left behind as the EU embarked on perhaps one of the most consequential institutional innovations in its history; and that even though the continued commitment to EMU and the willingness to pursue policies to achieve the criteria of EMU that were at times costly in the end would serve their national interest. This then makes the European experience distinct from other regional integration processes observed today.

European Economic and Monetary Union has proved to be a credible and successful remedy to an enduring European problem – namely, how to create a single internal market for capital, goods and services among member-states with highly interdependent economies in a world with multiple currencies, volatile capital flows, and fragile exchange-rate regimes.

4.1 Costs, Benefits and Long-Run Sustainability

The European Monetary System in 1979 was largely founded in response to the high and rising inflation in the seventies and the demise of the Bretton Woods System of fixed exchange rates. The functioning of the Exchange Rate Mechanism (ERM) in an environment of stability-oriented policies, contributed to the convergence of inflation in the participating countries to that of Germany, the low-inflation anchor. In addition the commitment to maintaining fixed exchange rates with the DM reinforced the benefit of lower mean inflation and helped to speed up convergence once supported by consistent policies.

The Maastricht Treaty of 1991 specified the conditions, EU Member States had to fulfill in order to be eligible for joining EMU. The requirements included the well-known macroeconomic convergence criteria and institutional requirements such as central bank independence.

These preconditions acted as a screening and commitment device such that governments showed their willingness to follow economic policies that did not impose costs on other members. Moreover, high nominal convergence was desirable to avoid large real exchange rate movements after the peg. The experience of the ERM I showed that the path towards a common currency is fraught with difficulties. ERM I painfully made clear that the internal adaptability of some economies participating was insufficient or not credible for a smooth working of the peg. The periodic crises and the recurring need for realignments within the ERM demonstrate that transition arrangements towards a currency union are only sustainable when economic policies are largely subordinated to the maintenance of the agreed exchange rate bands. The fact that the EMU countries were able to attain that goal highlights their strong political commitment to it.

Countries considering participation in a currency union expect that such a move will entail efficiency gains owing to an elimination of transaction costs associated with converting different national currencies as well as the elimination of risk associated with the uncertainty of the price-development of exchange rates[3]. A reduction in transaction costs also increases price transparency, eliminates price discrimination which could increase competition. Since the study of Engel and Rogers (1995) on the border effect[4], borders have been found to be very powerful in segmenting markets and for introducing large price differentials in addition to different national currencies. While the euro has not eliminated the border effect per se, it may prompt further integration in other areas which will counteract the border effect.

Uncertainty about the future price of a currency translates into uncertainty about future prices of goods and services which could distort the allocation of resources. A decline in the uncertainty of the real exchange rate can reduce adjustment costs and the price system can send better signals. In addition, price uncertainty can lead to moral hazard and adverse selection. The former because an increase in the interest rate owing to price uncertainty changes the incentives for borrowers; the latter because higher interest rates makes low-risk investment too expensive which in turn leads to an increase in the selection of more risky projects.

An elimination of exchange rate uncertainty may also increase economic growth. One channel is the real interest, which can cause an increase in the accumulation of capital and subsequently of the (temporary) growth rate[5]. Economic growth is further stimulated by the trade channel. Frankel and Rose (2000) found that a one percent increase in trade between countries of a currency union leads to an increase of per capita income of 1/3 of a percent. While their results have been widely contested and are at odds with similar literature that does not find an impact of exchange rate variability on trade[6], other evidence points to growth effect for countries belonging to a currency union. This, though could also be due to the standard endogeneity problem of currency unions. As Bacchante and

[3] For the euro area the European Commission estimated in 1990 that the gains of eliminating transaction costs could amount to EUR 13 to 20 billion per annum. Since these transaction costs are a deadweight loss, an improvement in welfare follows. These gains have increased with the elimination of fees for transfers within the euro area which was caused by the setting up of the TARGET system.

[4] Engel and Rogers (1995) found that crossing the Canadian-US border was equivalent to travelling 2,500 miles within the same country such that price differences between neighbouring Detroit (USA) and Windsor (Canada) are as high as the ones between New York and Los Angeles.

[5] In a dynamic setting, the economy can even attain a permanently higher growth path.

[6] See IMF (2003) for new evidence that underscores the traditional findings. For criticism of the Rose methodology see for example Tenreyro (2001).

van Win coop recently stated, "(…) the substantial empirical literature examining the link between exchange-rate uncertainty and trade has not found a consistent relationship" (Frankel et al., 2000, p. 1093).

In one of the more recent studies on possible trade creation resulting from EMU, Farquee (2004) finds that EMU has had a positive impact on intra-area trade. EMU increased trade among members by 10% since the advent of the euro. He also points to the fact that dynamic effects have been rising over time and are still increasing. But these gains are not evenly distributed: countries that have engaged predominantly in intra-industry trade within the EU have seen their area trade flows grow faster. Gains in trade should also not be deemed as necessarily guaranteed: structural policies such as ease of sectoral reallocation and market entry help realize full potential of trade gains from monetary union[7].

Fiscal rules[8] are based on political economy considerations. Public expenditure often is financed by debt issuance owing to inter-temporal redistribution considerations, thereby shifting the fiscal burden from today to the future. Fiscal rules are then an attempt to reign in the deficit bias of governments. They can act as a commitment device to prevent short-sighted political considerations leading to excessive spending and deficits and to limit discretionary fiscal policy. In a monetary union, undisciplined fiscal policies may impede a stability-oriented single monetary policy and would lead to negative spillovers.

The fiscal deficit and debt criteria which also form the cornerstone of the Stability and Growth Pact (SGP) were designed to ensure that countries were willing to bring their public finances onto a sustainable path. The aim was to avoid negative spillovers from the fiscal imbalances of individual member countries to other members through pressures for an undue relaxation of monetary policy or even a bailout of a government.

Fiscal rules are still an important issue for the long-run sustainability of a monetary union (Christl, 2003, Hochreiter et al., 2003). Fiscal rules also matter because monetary union membership can give rise to moral hazard and free-rider problems: Moral hazard because a member country is expected to be bailed out by others when faced with unsustainable debt levels; free-riding because fiscal laxity in one country can drive up the union-wide interest rate and can induce others to relax fiscal rules.

[7] An additional benefit of a common currency is wrought by its increased use as an international currency. See for example Portes and Rey (1998).

[8] How potential fiscal rules should be designed is a contentious issue. Trade-offs to be considered encompass transparency and simplicity against flexibility. If a fiscal rule is very flexible it probably is less simple and transparent and loses credibility. However, simple and transparent fiscal rules tend to be too mechanistic to flexibly accommodate business cycles.

Excessive deficits complicate monetary policy due to demand effects on prices and entail significant medium and long-run costs such as higher real interest rates and tax burdens. Besides, political pressure could be exerted upon the central bank to monetize government liabilities if the monetary authorities of a currency union are not sufficiently independent.

Since the market does not believe in the no-bail-out clause and, therefore, interest rate spreads are only a minor punishment for excessive deficits, fiscal rules are a necessary condition for a credible and successful monetary union. Therefore, rules such as the SGP are necessary to guard the culture of price stability and shift the focus of macroeconomic policies from domestic to currency-union-wide considerations. That's why ongoing discussions on a weakening of the SGP are not at all helpful in this respect.

4.2 Lessons so Far

With the successful cash changeover, the euro has become a familiar notion. While skepticism proliferated before its introduction, the experience so far suggests that the euro can be judged to be a success.

Possible lessons for others that can be learned from the European experience include amongst other things:

Monetary union is contingent upon the presence of monetary anchor currency with low inflation, strong economic integration and also on a strong political commitment focused on long-term gains.

But political union is not at all a requirement ex ante.

Outside factors such as systemic shocks and globalization can speed up the pooling of sovereignty in the economic domain.

Convergence criteria are necessary and act as a screening and commitment device to guide expectations.

To remain fully credible, a currency union requires policy coordination especially in the fiscal field coupled with an applicable enforcement mechanism as well as a forward-looking multilateral surveillance system.

5. Preconditions for Closer Monetary Integration in Other Regions?

5.1 Central and Eastern European Countries

After the end of communism, former socialist economies faced the difficulty of transiting from command to market economies. The early goal of EU accession framed the policies of Central and Eastern European Countries (CEEC) that have recently joined the EU and gave them a rationale for pursuing a substantial reform and adjustment effort. The prospect of subsequently joining EMU provides a further anchor both for monetary policy but also for the ongoing structural and institutional reforms.

Geographic and cultural proximity to Western Europe and a swift liberalization of trade enabled CEECs to redress distortions inherited from central planning and reallocate trade flows away from other transition economies towards Western Europe[9]. A proper sequencing of macroeconomic stabilization and structural reforms in the financial sector enabled many countries to return to international capital markets and attracted foreign direct investment.

Probably the most important effect has been the institutional reform process set in motion by preparing for EMU. Institutional factors play a central role in determining a country's rate of economic growth[10]. Douglass North (1990) suggested that it is the incentive structure embedded in the institutional structure of countries that must be the key to solving the mystery of unequal and unpredictable economic growth. Indeed, institutional constraints that foster distortionary policies and worsen economic vulnerabilities account for a significant part of cross-country differences in economic growth and output volatility (see Acemoglu et al., 2003). Institutional inertia could be punctuated by reforms required for the EU accession.

Previous enlargement rounds seem to have fostered an (endogenous) catch-up process of the joining countries leading to a reduction in the per capita income gap, a decrease in inflation, fiscal deficits as well as an increase in foreign direct investment and trade[11]. The prospect of joining the EU facilitated the adjustment of economic policies as well as the overhaul of institutions to meet requirements by the EU. But the prospect per se was not sufficient. Actual reform effort and implementation of policies were and are still required to bring about real as well as nominal convergence with existing EU members.

5.2 Latin America[12]

According to the Balassa-sequencing higher regional integration has two consequences: First, when regional integration leads from a free trade area to a single market, intra-regional exchange rate stability is of substantial importance to reap the benefits of such a move. Second, more exchange rate stability at the

[9] Between 1993-95 the EU concluded bilateral Europe Agreements with the CEEC which established free trade areas covering most products. See also Jean-Jaques Hallaert (2003).

[10] Dysfunctional institutions limit a country's productivity and potential growth because potential losers from change can effectively block institutional change given their vested interests.

[11] See also IMF (2003) for a detailed analysis of the process of economic convergence of CEECs.

[12] This section draws on Dorrucci et al. (2003).

regional level can be expected, if at least the stability orientation of monetary policies of the countries involved converge.

The very high intra-regional exchange rate variability in Latin America has served as an impediment for the regional integration process[13]. The Brazilian and Argentinean crisis disrupted the integration process of Mercosur even further rather than spurring regional economic coordination and cooperation. No attempts were made to achieve nominal convergence given that nominal exchange rate variability exceeds the real one. This is also owing to the fact that a credible commitment to regional economic integration is so far has been missing.

Latin American countries follow two different, though not mutually exclusive approaches to regional integration: (a) intra-regional arrangements such as Mercosur; (b) inter-regional arrangements like the Free Trade Area of the Americas (FTAA). Inter-regional arrangements probably limit countries to the establishment of free trade areas especially if one dominant partner rejects deepening of integration efforts. Intra-regional arrangements with the European experience in mind may benefit from deeper regional integration as a result of economies of scale, competition effects and improved resource allocation, which in turn could lead to a liberalisation of factor movements, policy harmonisation and policy coordination. Nevertheless, both options are viable ones and may or may not lead to a regional monetary arrangement.

Institutionally, Latin America is split into several sub-regional arrangements whose interdependencies are increasing only slowly. Mercosur has not taken on the role of engine for a consolidation of regional arrangements. Also, the supra-national element within Latin American regional arrangements is far less developed that within the EU. However, this proved to be instrumental in moving the European integration process further.

While Brazil is at first inspection the dominant Latin American country, it does not provide the region yet with a monetary anchor such as Germany did for the EU until 1998. Most Latin American countries are only now in the process of building-up credible monetary policies geared to price stability after decades of economic mismanagement and hyperinflation as well as institutions for the implementation for time consistent and credible policies, which is a time-consuming process. The only countries which may be on the verge of achieving this seem to be Mexico or Chile. The latter is too small while the former is more involved in NAFTA.

Latin American countries follow nearly the entire spectrum of the exchange rate continuum, comprising managed and independent floating sometimes coupled with

[13] The apparent increases in regional integration as witnessed by the rise in intra-regional trade is attributable to several factors such as the relative exchange rate stability between Argentina and Brazil during 1993 and 1998, IMF surveillance and programs that stressed inter alia an opening of economies and a relatively favourable world economic environment.

inflation targeting as well as dollarization. But none of the Latin American exchange rates has acquired an anchor role for neighbouring countries whereas European exchange rates before EMU where either floats or anchored with respect to the Deutsche mark although a plethora of domestic monetary anchors existed (growth of money supply, interest rates, exchange rate). In addition, Latin American countries are subject to the third currency and interest rate phenomenon with the fluctuations of the USD and U.S. interest rates still creating substantial problems for the region. The different exchange rate regimes employed in Latin America seem appropriate owing to the differences in income levels and (external) economic developments. A currency union therefore may not be appropriate for the time being as long as the third currency problem persists and economic conditions have not stabilized.

As a first step, the region may benefit from anchoring as a group to an outside currency such as the euro or US dollar. A basket including both the dollar and the euro may be beneficial since it is not clear which of the two main international currencies would provide the anchor for the region[14]. Alternatively, inflation targeting (see below) could create the conditions conducive to pursue first regional integration and second monetary integration in the medium to the long-term.

5.3 Asia

To a certain extent, the Asian financial crisis of 1997-98 acted similarly as an exogenous shock to promote Asian monetary cooperation as the demise of the Bretton Woods system of fixed exchange rates did for Europe. The main institutional arrangement became the Chiang Mai Initiative[15] agreed upon by the ASEAN plus 3 which mainly acts as a form of self-insurance in case of another financial crisis. Subsequently, a more significant step was the decision by the Executive's Meeting of East Asia-Pacific Central Banks (EMEAP) to set up the Asian Bond Fund (ABF) in dollar-denominated instruments in 2003. The ABF primarily aims at developing a regional bond market. The significance of this is twofold: in Europe monetary cooperation and ultimately currency union was

[14] South America trades with Europe to a large extent, and in many cases the business-cycle co-movements are as high with the euro area as with the United States.

[15] The Chiang Mai Initiative is basically a bilateral swap arrangement (BSA) facility for short-term liquidity assistance in the form of swaps of USD with the domestic currencies of participating countries. Countries drawing more than 10 percent are required to accept an IMF program. The BSA however is complementary to IMF financial assistance otherwise a regional surveillance system would be needed. Thus, IMF surveillance continues to be the main agency for monitoring economic developments in the region and serves as the institutional framework for policy dialogue and coordinating members and impose structural and policy reform on countries drawing facilities.

supported and promoted by the respective European central banks. Second, the ABF creates an operational framework which should advance and focus monetary cooperation.

Yet, Asian regionalism has several characteristics that distinguish it from the EU. First, Asian regionalism is pluralistic. There is no single dominant organization that supplies continental regional integration in the manner of the EU. Membership of many of these organizations is often overlapping. This relates to the ambiguity in defining an economic region in Asia[16] which is owing to a lack of similarity in levels of development and lack of real convergence: as a general rule, the benefits of monetary integration are greater, and the costs lower, for countries which have similar levels of income and economic development. Asia is geographically quite disparate and there are significant differences in basic economic indicators which are narrowing only slowly.

Goals of the various regional Asian organizations are so far more modest than in the EU. The Asia-Pacific Economic Cooperation (APEC) proposes to eliminate trade and investment barriers between its richer members by 2010 and by 2020 for its poorer members. It is no more than a possible free trade area. Originally, ASEAN was not conceived as an economic community. Domestic resistance to free trade and liberalisation have managed to keep them largely off the organisation's agenda such that ASEAN is not a model of economic regionalism.

And not only is Asian regionalism a fairly recent phenomenon it also appears that the political will is lacking given that the *natural* leadership role is contested: China, Japan and to a certain extent India are vying for a regional hegemon position. No country seems to act as the monetary anchor for the region[17]. In analogy to the EU experience, China and Japan probably have to go the same way of reconciliation that France and Germany have taken before any serious deepening of regionalism can be considered.

5.4 General Observations

Even though OCA criteria are met only to varying degrees in both regions, more regional integration should not be ruled out. But rather than looking at static OCA criteria, the political willingness supported by realistic objectives as well as

[16] Japan can be placed in a group of mature developed countries. Some countries belong to a high growth Asian group other exhibit more moderate growth. Hong Kong and Singapore form a group of their own as does China which was markedly different from the rest of Asia.

[17] Although many other Asian countries could be said to have informally formed a renimbi-zone with China as the anchor but in contrast to the European experience, the primary motivation for this is exchange rate stability and fear of loss of market share to China rather than attempts to integrate trade or have convergent prices or policies.

regional economic conditions are instrumental whether regional integration will proceed further.

Obstacles exist that impede further regional integration in Latin America and Asia. If an increase in regional trade is the objective, this could be achieved with the right Balassa-sequencing. Some of the intra-regional arrangements are limited in membership similar to the initial EU of 6. Those could form a cluster for deepening trade relations leading to increased cooperation and policy coordination. In particular, the limited membership in Mercosur could make negotiations and co-ordination potentially easier if favourable economic circumstances arise, as happened in the early 1990s and if real convergence proceeds. Of particular relevance will be the external environment: Negative external shocks leading to domestic macroeconomic instability have so far delayed regional integration in Latin America whereas they may have accelerated it in Asia though more in respect to regional monetary stability. Fear of an erosion of political sovereignty or domination by larger countries have hampered real integration efforts. Weak domestic institutions and policy inconsistence have failed to provide a credible basis for most integration efforts.

A regional surveillance mechanism and macro-economic co-operation would suit the need to strengthen nominal stability. Multilateral surveillance has especially helped former EU periphery countries to earn credibility, which transformed the ERM from an exchange rate arrangement into a convergence instrument. But already exchange rate co-operation could lower the magnitude of internal shocks produced by abrupt swings in the nominal exchange rate between the main Asian/Latin American currencies.

A monetary union may also play a role – especially for small open economies – in reducing the relative degree of trade openness, which may contribute to partly shielding the region from external shocks. Enhanced nominal stability and a lower relative degree of openness would help reducing the overall vulnerability. It could be easier to foster market-friendly reform in a regional framework than only within the global context. Finally, deeper integration could also be associated with political benefits such as stronger visibility and bargaining power in the international arena.

But also a non-Balassian approach to regional integration may be conceivable. The relative success of the EMU predecessors in stabilizing their bilateral exchange rates especially the nominal convergence achieved, suggests that exchange rate cooperation or soft exchange rate stabilization objectives, may set the stage for gradual integration. If business cycles are not too asymmetric, a common anchor could facilitate intra-regional exchange stability (Artis, 2002). Most Asian countries have chosen the U.S. Dollar or the renimbi as an explicit or implicit anchor. While this move requires little cooperation, this has already lead to an increase in regional trade, thus reducing the relative degree of trade openness and shielding the region from external shocks. More stable exchange rates and lower trade openness would also reduce overall vulnerability.

6. Stability-Oriented Macro-Policies as an Alternative?

For the reasons mentioned before, for many countries or regions in the world forming a currency union is not a realistic goal in the near future mainly owing to a lack of political will, lack of credible and consistent policies as well as the absence of dominant countries driving such a development. On the other hand, a prosperous development of the world economy needs fair and relatively stable exchange rates to stimulate world trade and the international division of labor. Exclusive policy reliance on the stability of the exchange rate with the exchanger rate entering the monetary authority's objective function directly has often not lead to the desired outcome of stable macroeconomic polices. A necessary precondition for such a development is stability oriented monetary and fiscal policies.

Traditional monetary policy frameworks to achieve low inflation and sustainable growth rested upon intermediate variables such as monetary aggregates to anchor expectations. This concept is often not suitable for EMCs mainly because of instable money demand functions. Targeting of the exchange rate as practiced to varying degrees in Latin America or Asia has not been successful. Experience in some EMCs has shown that an explicit inflation target could provide a credible anchor for inflation expectations. Thus, inflation targeting (IT)[18] may be a successful strategy for larger EMCs to provide the macroeconomic stability desired and to have at the same time enough flexibility for coping with external shocks. Price stability and sound fiscal policy would clearly be preconditions for further monetary integration in the future.

The quite successful experience with IT in a number of industrialized countries has increased the interest in this monetary policy framework also in emerging markets. Hungary, the Czech Republic, Poland, Brazil, Mexico, Thailand or Korea have already moved towards a direct or indirect form of IT.

Generally, IT requires that (a) the central bank is independent such that (b) it can commit to having low and stable inflation as the overriding objective of monetary policy, (c) the central bank announces a point or range target for the

[18] Monetary targeting tries to stabilize the inflation rate around the target value supposing a stable empirical relationship of the monetary target to the inflation rate and on its relationship to the instruments of monetary policy. Many emerging markets however have very instable money demand due to price shocks. With an exchange rate rule, monetary policy is constrained and cannot react to domestic or external shocks and in developing countries/EMCs the exchange rate itself can be a source of instability due to for example, real appreciation of the exchange rate (the Harrod-Balassa-Samuelson effect).

inflation rate and (d) clearly communicates and transparently details the instruments that will be used to achieve and maintain the inflation target.

IT could be useful in several aspects for EMCs. But the potential benefits are also closely linked to implementation issues that many EMCs have to address[19] in order to achieve sustained macroeconomic stabilization and growth.

IT could be a helpful coordination device for inflation expectations;

Since IT requires an independent and credible central bank, this could have positive externalities for the credibility of economic policy in general, though, it also could lead to tensions between the central bank and the government.

If the rule guiding IT is kept sufficiently flexible, it would leave the central bank room for manoeuvre to address domestic as well as foreign shocks; and at the same time it can also focus the public on the real tasks of a central bank which is the control of prices rather than raising long-term growth.

IT could help address the issue of fiscal dominance (i.e. high levels of government deficits and dependence on seigniorage) – which is relevant for any regime.

On the exchange rate inflation nexus Eichengreen (2001) suggests that the IT framework should be extended to account for the shocks that emerging economies are prone to. If EMCs are considering IT challenges are (i) forecasting of inflation in a volatile environment, (ii) liability dollarization/euroization which may affect the credibility of IT regime and could cause a conflict between different nominal anchors and (iii) the openness of the economy which will have implications for the exchange rate channel of monetary policy[20] and (iv) the degree of price indexation.

The experience of Brazil or Chile shows that countries can make encouraging progress in reducing inflation and can gain credibility. Another benefit, as pointed out by Bernanke et al., is that the framework is not an automatic Friedman-like rule but rests on constrained discretion: Chile and Brazil, for example, have implemented IT gradually and flexibly targeting a *long-run* inflation rate which removes temporary exchange rate effects. This has helped to reduce inflation

[19] Operational issues such as whether to target a point or a range of inflation, the time horizon of inflation targeting and which measure of inflation to target are not considered here (see for example Bernanke et al., 1999)

[20] External shocks often cause strong exchange rate movements in EMCs which translate directly into inflationary pressures that may destabilize the economy. A central bank then may be unwilling to let the exchange rate move and will intervene in the forex market (fear of floating argument) such that the conflict between differing nominal anchors has to be addressed. In addition, explicit or implicit price indexation can lead to inflation inertia which could complicate IT implementation. In order to take account of the exchange rate, EMCs could use a monetary conditions index consisting of the interest rate and exchange rate. However, an MCI could have detrimental effects on employment and output.

without incurring substantial output costs[21]. Therefore, a case can be made for IT in EMCs to frame policy since policymakers will have to deepen financial and fiscal reform, enhance transparency and improve the fiscal stance, in addition to converging to international levels of inflation. Otherwise an inflation target could become non-credible with costs at least as large as the one from a non-credible exchange rate peg[22]. But as Mervyn King (2004, p. 7) has observed: “Inflation targeting is a way of thinking about policy. It isn’t an automatic answer to all the difficult policy questions." However, IT probably should be accompanied by some fiscal policy rule with a view to constrain fiscal policy, discretionary intervention and thereby conferring credibility on the conduct of policy. Similar to the IT suggested for EMCs, these fiscal rules[23] will have to be a lot more discretionary than in developed countries owing to the inherent macroeconomic volatility and poor macroeconomic management. Fiscal rules in addition to IT would be important building stones of the economic institutional infrastructure; the former protecting fiscal discipline through time, the latter ensuring monetary discipline through time.

7. Conclusions

The successful completion of EMU and the introduction of the euro have substantially increased the general interest in regional integration and especially in regional monetary arrangements. The EU experience is not a blueprint for regional integration that can be applied directly and in its entirety to other regions. Unreflective comparison could therefore, lead to the dangerous trap of euro centrism.

It is tempting to see European regionalism and monetary union as a template or basic model because it is so long-standing; the EU has achieved incredible depth and has build up accompanying institutions. Most academic models of political and economic integration have so far been devised with Europe in mind or are drawing upon the European experience. The expectation then would be that *orthodox* integration involves depth via a creation of a single market and/or monetary union as well as institutionalisation through the development of supranational institutions.

[21] Though the experience of these and other countries could be subject to *mean reversion*.

[22] A necessary precondition for IT would have to be prior inflation reduction otherwise it will be difficult to publicly identify the target, which consequently will be missed, jeopardizing the central bank’s credibility. In addition, in the presence of high foreign currency liabilities, IT may lead to volatile exchange rates amplifying balance sheet effects.

[23] These fiscal rules could be limits on the government budget deficit, public borrowing or public debt and could be targeted at different levels of government, preferably with an effective sanctioning mechanism for non-compliance.

But the European experience may not be the standard form integration has to take. Especially since European monetary integration did not itself proceed upon traditional lines, which postulates that monetary union is not possible or bound to fail without political union.

If institutional and economic integration were to proceed according to the European template, this would likely imply deeper monetary and exchange rate co-operation. However, the question of whether the political willingness and the other ex-ante requirements for deeper integration exist in other regions remains open to discussion. Discussion is therefore alive on longer-term options for respective exchange rate regimes such as joint anchoring to an outside currency or to a basket of currencies, the adoption of a common regional currency or floating against third currencies. However, the challenge more often seems to be whether credible institutions exist which will get the fundamentals right and which facilitate the implementation of consistent stability-oriented macroeconomic policies. While not a panacea, some regions depending on their overall macroeconomic strategy may be better served with introducing first an inflation-targeting regime accompanied by some fiscal rule rather than opting for a currency union.

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East Asia's Contribution to a Stable Currency System

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1. Introduction

Over the last two decades, the East Asian economies have achieved remarkable economic growth. One major engine of this success has been the expansion of foreign trade and direct investment (FDI). Since the early 1990s, emerging East Asia has also experienced increasing financial openness. Financial openness contributed to rapid economic growth by attracting both long-term and short-term capital and, together with trade and FDI openness, deepened market-driven economic interdependence in East Asia. But it added financial vulnerabilities, culminating in the form of a currency and financial crisis in 1997–98.

The crisis was a devastating experience for many East Asian economies because it exposed both the danger of financial globalization and the structural weaknesses of their economies. While it was a painful experience for many – because of the intervention by the International Monetary Fund (IMF) a sharp downturn of economic activity and social and political costs – it stimulated debates concerning a new international financial architecture, including the role of the IMF, desired pace and sequencing of capital account liberalization, and appropriate exchange rate regimes. One of the most noteworthy outcomes of the crisis was that the East Asian economies have embarked on regional monetary and financial cooperation. The crisis prompted the regional economies to realize the importance of managing financial globalization through closer cooperation among their financial authorities and to undertake various initiatives for the institutionalization of regional financial interdependence. For example, the ASEAN+3 members – comprising ASEAN, China, Japan and Korea – began to undertake the Chiang Mai Initiative, economic surveillance and policy dialogue, and the Asian bond market development initiative.

The objectives of this paper are fourfold. First, it shows that the regional economies are increasingly integrated with each other through trade, FDI and finance and are now highly interdependent in macroeconomic co–movements. However, there have not been formal institutions to support such interdependence. Second, it argues that the recent move toward monetary and financial cooperation has led to the emergence of a new regional financial architecture, and this move is a reflection of the region's intention to institutionalize rising economic interdependence among themselves as well as its defensive reaction to the crisis. Third, for increasingly interdependent East Asian economies, intra-regional exchange rate stability is important. The paper hence emphasizes the importance of further institution building that can lead to the creation of a regional mechanism for exchange rate stabilization. Finally, the paper argues that East Asia's monetary and financial regionalism can contribute to the stability of global finance, while remaining consistent with the global framework of the IMF.

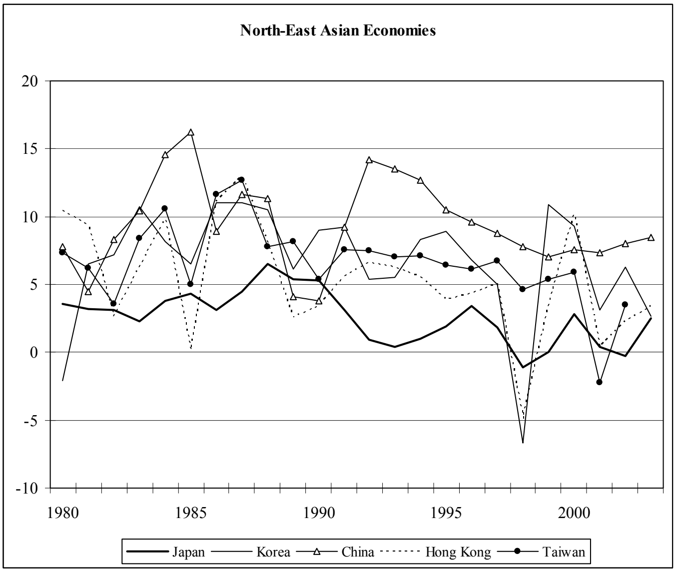
The organization of the paper is as follows. Section 2 overviews recent macroeconomic developments of major East Asian economies and identifies the extent of macroeconomic interdependence in the region. Section 3 summarizes the impact of the East Asian crisis on monetary and financial regionalism in East Asia. Section 4 reviews the current states of regional financial cooperation, explains the logic of such cooperation, and investigates the challenges for greater institutionalization of regional financial integration. Section 5 takes up the issue of exchange rate arrangements in East Asia. Section 6 provides concluding remarks.

2. Macroeconomic Developments and Interdependence in East Asia

2.1 Recent Macroeconomic Developments

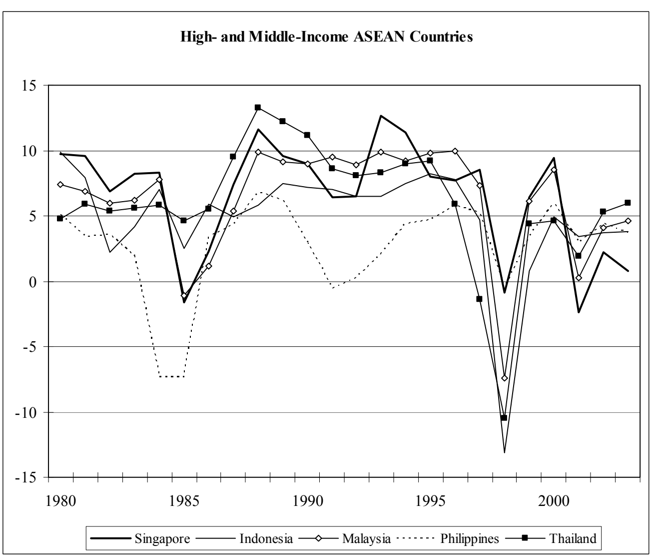
Growth and inflation. Almost all East Asian economies exhibited strong growth performance in the 1980s and the first half of the 1990s. However, many of them experienced negative growth in 1998, not only in crisis-affected economies – Indonesia, Thailand, Malaysia, Korea and the Philippines – but also in countries like Japan, which had its own domestic financial crisis, Hong Kong and Singapore. Japanese economy grew at 3.8% in the 1980s with low inflation, but slipped into a long period of stagnation in the 1990s. For example, the average annual growth rate of real GDP was 1.1% in the post-bubble decade, 1992–2002. More recently, the economy experienced near-zero growth – at 0.1% in 1998–02 (chart 1). The economy was in a systemic banking sector crisis between the fall of 1997 and much of 1998. But the economy started to recover in the second quarter of 2002 and has recorded positive growth for eight consecutive quarters owing to the resolution of bank and corporate sector restructuring.

Chart 1a: Real GDP Growth Rates of the East Asian Economies, 1980–2003



Source: IMF, Bank of China for Taiwan.

Chart 1b: Real GDP Growth Rates of the East Asian Economies, 1980–2003

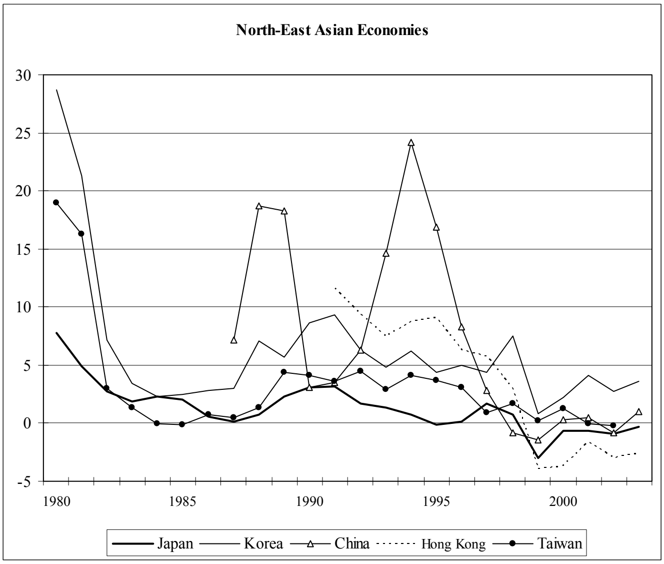


Source: IMF, Bank of China for Taiwan.

After three decades of remarkable economic growth, the five crisis-countries fell into a severe recession in 1998. The economic crisis in these countries has caused a serious setback in development performance, but at the same time has provided a window of opportunity to strengthen domestic policies and institutions through wide-ranging structural reforms. They started recover strongly in 1999 due to their restructuring efforts and structural reforms that focused on banking and corporate sectors. However, the post-crisis growth pattern indicates that the ASEAN countries are like to grow at rates lower than the pre-crisis pattern, which may ensure the sustainability of growth. China continues to perform well, though it shows a sign of overheating due to overinvestment in construction and certain materials sectors.

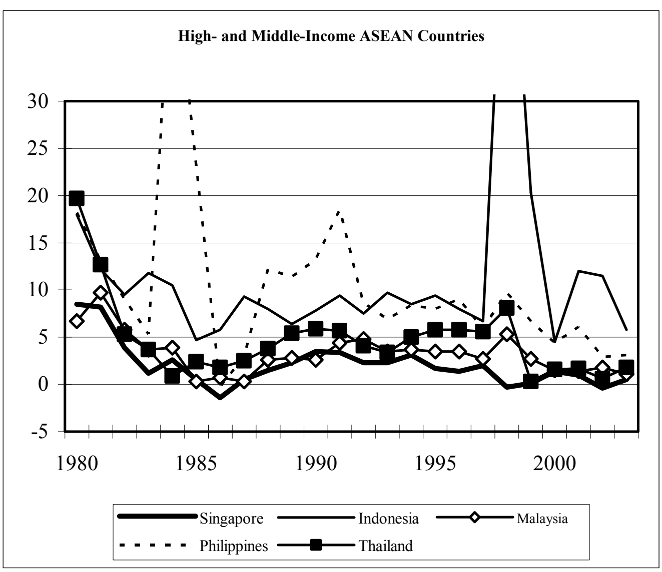
Japan’s rate of inflation in the 1980s was low – 2.5% for the CPI – and it was even lower in the 1990s – 0.2% for the CPI in 1992–2003 (chart 2). Until recently, the price level fell faster, recording an average 0.7% decline in the CPI per year during 1999–2002. But the rate of deflation moderated in 2003. With economic recovery and quantitative monetary easing fully in place, price deflation is expected to halt within a year or two. China also experienced price deflation in 1998–99 and 2002, after having undergone a rapid inflation in the mid-1990s. There is a great deal of inflation rate convergence among the North-East Asian economies and some ASEAN countries – like Singapore, Thailand and Malaysia – in the last few years. Though Indonesia appears to have arrested the high inflation rates of the crisis period – 58% in 1998 and 20% in 1999 – it still faces relatively high inflation.

Chart 2a: CPI Inflation Rates of the East Asian Economies, 1980–2003



Source: IMF, Bank of China for Taiwan.

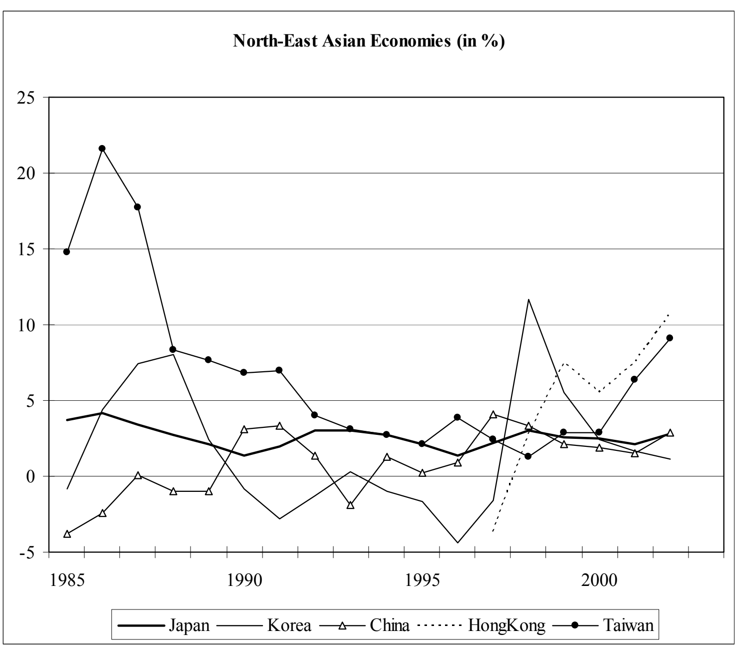
Chart 2b: CPI Inflation Rates of the East Asian Economies, 1980–2003



Source: IMF, Bank of China for Taiwan.

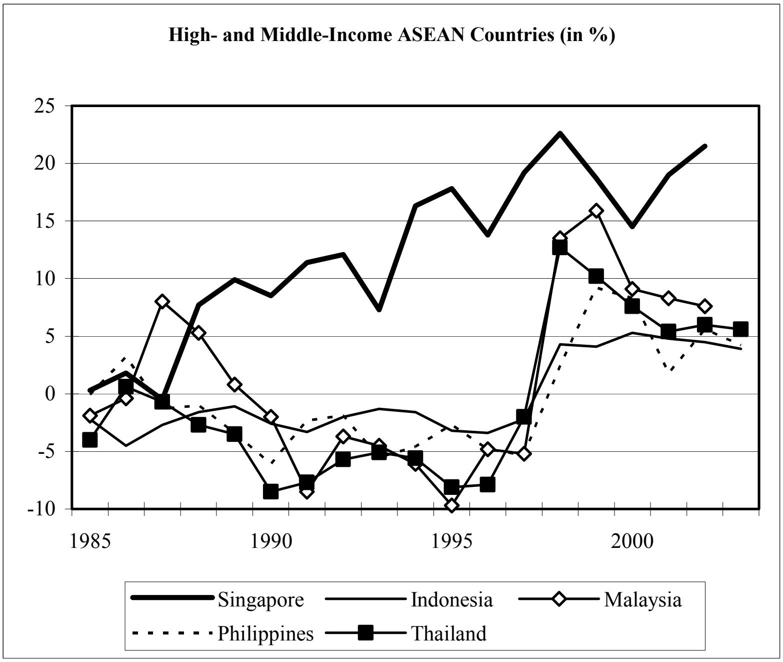
Current accounts. Emerging economies in East Asia recorded current account deficits during most of the 1990s until the currency crisis with the exception of Singapore and Taiwan (chart 3). Singapore registered ever-rising current account surpluses and Taiwan maintained steady levels of current account surpluses at 5% of GDP or less. Japan also maintained steady current account surpluses at about 2% to 3% of GDP. China's current account position has been sound, recording 2% to 3% of GDP. In contrast to these economies, Korea and the middle-income ASEAN countries had persistent current account deficits throughout most of the 1990s. When these countries were hit by the financial crisis in 1997–98, there were massive current account adjustments. Over the course of two years between 1996 and 1998, the current accounts of Thailand and Malaysia shifted from minus 5% or more (in absolute value) to 13%. A similar swing was observed in Korea, the Philippines and Indonesia, though the magnitude of adjustment was smaller. These adjustments were brought about mainly through domestic demand contraction.

Chart 3a: Current Account/GDP Ratios of the East Asian Economies, 1985–2003



Source: IMF, Bank of China for Taiwan.

Chart 3b: Current Account/GDP Ratios of the East Asian Economies, 1985–2003



Source: IMF, Bank of China for Taiwan.

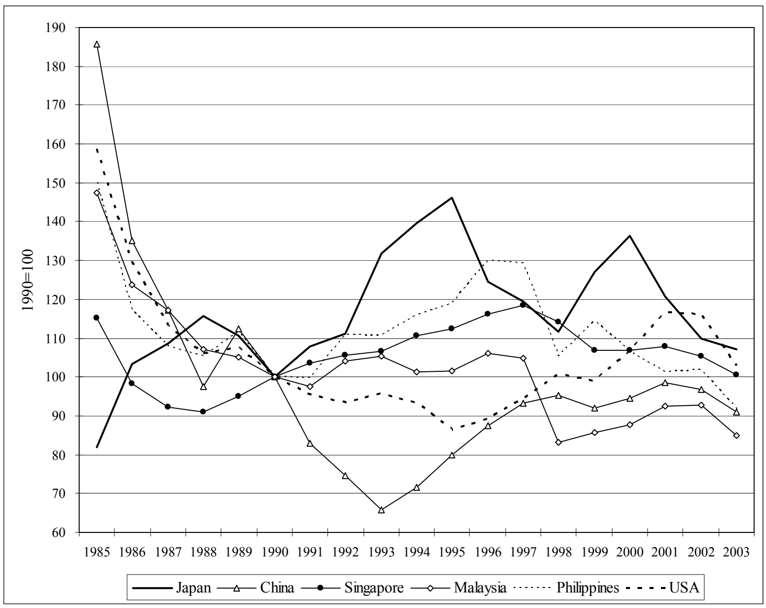
Since after the crisis, all the economies in East Asia have been running current account surpluses. The underlying cause for this is that the level of domestic investment has come down significantly in comparison to the pre-crisis period. The presence of excessive capacity and the restructuring efforts have encouraged firms to invest less than before. The relatively low level of investment is expected to continue for some time to come, which can sustain trans-Pacific current account imbalances for the foreseeable future.

Exchange rates. Chart 4 plots real effective exchange rates for selective East Asian economies and the United States with the year 1990 as 100[1]. The chart indicates that following the Plaza Accord, the yen continued to appreciate as a trend until 1995, when the currency started to depreciate as a trend though there was another appreciation episode in 2000. This trend was associated with the U.S. dollar's trend depreciation between 1985 and 1995, and its trend appreciation between 1996 and 2001. The Chinese renminbi (RMB) underwent a spectacular depreciation between 1985 and 1993. Despite the currency devaluation in 1994 the

[1] Year 1990 is taken as the base year because of the absense of large current account imbalances for Japan and the United States.

real effective value of the RMB appreciated until 1998 largely because of domestic high inflation in the mid 1990s.

Chart 4: Real Effective Exchange Rates of Selected East Asian Economies and the U.S.A.



Source: IMF, International Financial Statistics.

The currencies of crisis-affected countries have depreciated as a result of the crisis. Currently the real effective exchange rate of the Malaysian ringgit is roughly 15% less than the 1996–97 level, while that of the Philippines peso has been down by 30%.

2.2 Capital Flows

Patterns of capital flows. Table 1 summarizes the recent patterns of net capital flows in East Asia. One can observe different patterns across Japan, China and crisis–affected economies.

Table 1: Net Capital Flows in East Asia (in Billion USD)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Japan									
Total capital flows, net	–85.1	–64.0	–28.0	–120.5	–114.8	–38.9	–78.3	–48.2	–63.4
Direct investment, net	–17.2	–22.5	–23.2	–22.1	–21.4	–10.0	–23.3	–32.3	–23.0
Portfolio investment, net	–27.4	–26.2	–33.8	32.1	–39.2	–27.5	–36.0	–46.3	–106.0
Other capital flows, net	–40.5	–17.3	29.0	–110.5	–54.2	–1.4	–22.0	30.4	65.6
Memorandum items									
Changes in reserves[a]	–25.3	–58.6	–35.1	–6.6	6.2	–76.3	–49.0	–40.5	–46.1
Current Account	130.3	111.0	65.8	96.8	118.8	114.6	119.7	87.8	112.5
China									
Total capital flows, net	32.6	38.7	40.0	21.0	–6.3	5.2	2.0	34.8	32.3
Direct investment, net	31.8	33.8	38.1	41.7	41.1	37.0	37.5	37.4	46.8
Portfolio investment, net	3.5	0.8	1.7	6.9	–3.7	–11.2	–4.0	–19.4	–10.3
Other capital flows, net	–2.7	4.0	0.2	–27.6	–43.7	–20.5	–31.5	16.9	–4.1
Memorandum items									
Changes in reserves[a]	–30.5	–22.5	–31.7	–35.9	–6.2	–8.7	–10.7	–47.4	–75.2
Current account	6.9	1.6	7.2	37.0	31.5	21.1	20.5	17.4	35.4
Crisis-affected countries[b]									
Total capital flows, net	33.3	62.5	74.9	–13.1	–33.5	–12.5	–15.8	–12.1	–7.1
Direct investment, net	6.4	8.4	11.1	12.4	11.8	12.4	6.3	2.7	2.6
Portfolio investment, net	11.2	20.6	28.7	16.6	–3.4	13.1	7.2	6.2	0.0
Other capital flows, net	15.7	33.5	35.2	–42.1	–41.9	–38.0	–29.4	–21.0	–9.7
Memorandum items									
Changes in reserves[a]	–8.5	–14.9	–14.6	33.4	–46.4	–39.5	–26.0	–9.0	–23.2
Current account	–22.2	–39.1	–53.8	–26.4	69.8	62.5	44.3	30.0	33.0

Notes: (a) A minus sign indicates an increase in foreign exchange reserves.
(b) Indonesia, Korea, Malaysia, the Philippines, and Thailand.
(c) 24 economies in Asia and the Pacific, including Korea and Singapore (but excluding Taiwan).

Sources: IMF, International Financial Statistics (CD-ROM).

First, Japan recorded persistently net capital outflows throughout the period, in response to its persistent current account surpluses. There net outflows in both foreign direct and portfolio investments throughout the period, except in 1997 when residents portfolio investment declined substantially. Second, China recorded persistently net capital inflows, particularly in the form of inward foreign direct investment, despite its persistent current account surpluses. The net result is persistent accumulation of foreign exchange reserves. Third, the five crisis-affected countries experienced a large swing of net capital flows from net inflows in the pre-crisis period to net outflows in the post-crisis period. These economies received foreign direct investment persistently, and what caused such a large swing was a reversal of “other capital flows” such as bank flows. After recording a net inflow of USD 70 billion in 1996, the private capital account of the East Asia-5 registered a net outflow of USD 45 billion in 1997–98, causing a capital flow reversal of USD 113 billion over the course of two years. Though East Asia is expected to continue to experience net outflows of private capital, net inflows of foreign direct investments and portfolio equity investments are expected to return as economic growth is sustained.[2]

Foreign exchange reserve accumulation. What is noteworthy is the fact that in the post-crisis period, East Asia is accumulating foreign exchange reserves in a massive way. Table 2 shows that in the 1990s, the East Asian economies have accumulated by more than USD 1.5 trillion, close to 70% of the world total increase. As a result, East Asia how holds close to USD 1.8 trillion of foreign exchange reserves. Not only Japan and China, but also Taiwan and crisis-affected economies have been accumulating reserves. Part of the reason for this is the lesson from the financial crisis: A large war chest is needed to counter a liquidity crisis. For Japan, prevention of rapid yen appreciation has been one of the few policies left for the authority to fight against price deflation and get out of the prolonged stagnation.

Table 2: Foreign Exchange Reserve Holdings of the East Asian Economies

Economies/Regions	1990	1995	2000	2001	2002	2003	(FXR/IMP)
Japan	78,501	183,250	354,902	395,155	461,186	663,289	1.73
Korea	14,793	32,678	96,130	102,753	121,345	155,284	0.87
China	29,586	75,377	168,278	215,605	291,128	408,151	0.99
Hong Kong	24,570	55,400	107,540	111,160	111,900	118,360	0.51
Taiwan	72,442	90,311	106,741	122,208	161,654	206,636	1.43
Singapore	27,748	68,695	80,132	75,375	82,021	95,746	0.75
Indonesia	7,459	13,708	28,502	27,246	30,969	34,962	0.84
Malaysia	9,754	23,774	29,523	30,474	34,222	44,515	0.54
Philippines	924	6,372	13,047	13,429	13,135	13,457	0.34
Thailand	13,305	35,982	32,016	32,355	38,046	41,077	0.54
East Asia-10	279,082	585,547	1,016,811	1,125,760	1,345,606	1,781,477	1.03
Asia Total	284,761	613,724	1,069,140	1,189,034	1,437,072	1,911,428	1.03
World Total	932,533	1,469,25	2,021,221	2,141,825	2,513,584	3,141,994	0.41

Note: (a) FXR/IMP is the ratio of foreign exchange reserves to imports for 2003, except for Taiwan (2002).

Source: International Monetary Fund, International Financial Statistics.

[2] Though brighter, most of these private flows have concentrated on one or two countries (Korea and China), leaving the rest of East Asia behind.

2.3 Deepening of Financial Integration and Macroeconomic Interdependence

One of the most important developments is the deepening of regional macroeconomic interdependence in East Asia.

Trade and FDI integration. East Asia has long enjoyed a market-driven expansion of trade and foreign direct investment (FDI) and the resulting *de facto* integration of the regional economies, within a multilateral liberalization framework under the GATT/World Trade Organization (WTO) and open regionalism through Asia-Pacific Economic Cooperation (APEC). A key feature is that the region has avoided discriminatory trade practices. The APEC process was successful in encouraging China – as well as Taiwan – to pursue trade and FDI liberalization outside of the WTO framework. Regional economic integration has been strengthened through an expansion of trade and FDI.

Table 3a: Intra-Regional Trade Share[(a)] (in %)

Regions	1980	1985	1990	1995	2000	2001
East Asia-10, including Japan[(c)]	33.6	36.2	41.6	50.1	50.1	50.8
Emerging East Asia-9[(d)]	22.6	26.3	32.8	38.4	39.5	41.0
NIEs-4	8.5	9.5	12.3	14.0	13.6	13.2
ASEAN-4	3.5	4.9	3.9	5.2	7.9	7.9
NAFTA	--	36.6	36.8	41.9	46.5	46.3
European Union-15	52.6	53.8	64.9	64.1	62.1	61.9

Table 3b: Intra-Regional Trade Intensity Index[(b)]

Regions	1980	1985	1990	1995	2000	2001
East Asia-10, including Japan[(c)]	2.31	2.02	2.08	1.99	2.06	2.22
Emerging East Asia-9[(d)]	3.02	2.66	2.66	2.19	2.23	2.44
NIEs-4	2.00	1.62	1.56	1.31	1.32	1.41
ASEAN-4	1.58	2.27	1.45	1.28	2.15	2.17
NAFTA	--	1.82	2.06	2.28	2.10	2.12
European Union-15	1.39	1.55	1.45	1.66	1.73	1.67

Note: (a) The intra-regional trade share is defined as: $\{(X_{ij}/X_{i.}) + (X_{ij}/X_{.j})\}/2$ where X_{ij} represents exports of region i to region j, $X_{i.}$ represents total exports of region i, and $X_{.j}$ represents total exports of the world to region j (or total imports of region j). In the table, the share is defined only for economies within the same region, so that i=j.

(b) The trade intensity index is defined as: $(X_{ij}/X_{..})/\{(X_{i.}/X_{..})(X_{.j}/X_{..})\}$ where X_{ij} represents exports of region i to region j, $X_{i.}$ represents total exports of region i, $X_{.j}$ represents total exports of the world to region j (or total imports of region j), and $X_{..}$ represents total world exports. In the table, the index is defined only for economies within the same region, so that i=j.

(c) East Asia-10 includes Emerging East Asia-9 and Japan.

(d) Emerging East Asia-9 includes NIE-4 (Korea, Taiwan, Hong Kong, and Singapore), ASEAN-4 (Malaysia, Thailand, Indonesia, and the Philippines) and China.

FDI flows to the emerging East Asian economies, driven largely by Japanese multinational corporations after a steep yen appreciation following the Plaza Accord of 1985, expanded rapidly in the second half of the 1980s. Multinational corporations began to fragment their production process into different sub-processes and locate each of them in countries according to the required factor proportions and technological capabilities. Such a strategy has generated a web of intra-regional, intra-industry trade in parts, components, semi-finished products, and finished products within East Asia, contributing to an efficient division of labor and deep economic integration. The resulting FDI-trade nexus is a distinct feature in the region. More recently, China's rise as an economic powerhouse has also been accompanied by its expansion of, and rising linkages through, trade – particularly intra-industry trade – with other East Asian economies, most of which are generated by multinationals.

The degree of regional integration through trade in East Asia has been rising fast over the last twenty years. Table 3a summarizes changes in the share of intra-regional trade for various groupings in the world over the period of 1980–2001. The table demonstrates that the share of intra-regional trade for East Asia in its total trade has risen from 23% in 1980 to 41% (excluding Japan) or from 34% to 51% over the same period (including Japan). This trend means that more than 50% of East Asia's recent trade is with itself. The share of intra-regional trade within East Asia is still lower than that in the European Union (62%), but exceeds that of the North American Free Trade Area (NAFTA) (46%) in 2001. Table 3b summarizes changes in the intra-regional trade intensity indices for the same groupings over the same period.[3] The table demonstrates that within East Asia, whether including Japan or not, the trade intensity indices are larger than those for NAFTA or EU-15. This observation confirms that the degree of regional integration through trade in East Asia is quite large and comparable to levels seen in North America or Europe.

Financial and macroeconomic interdependence. Market-driven financial integration has also been underway as a result of the increased deregulation of the financial system, opening of financial services to foreign institutions, and liberalization of the capital account in the East Asian economies. Commercial banks have extended cross-border loans to banks and corporations throughout the region, and such banks have contributed to a closely connected banking sector within East Asia. The Opening of securities markets, particularly equity markets, has attracted foreign portfolio capital inflows. Active commercial bank loans and portfolio flows have linked the economies in the region financially, creating positive correlations of asset price movements within the region. At least part of

[3] The advantage of trade intensity indices over trade shares is that the former control for a region's relative size in world trade and, hence, present a better measure of closeness of the economies within a region.

the contagion of currency crises in the region in 1997 was a reflection of such financial linkages.

Macroeconomic interdependence within the region has recently become stronger, as evidenced by a simultaneous contraction of economic activity throughout East Asia in 1998 and a simultaneous expansion in 1999–2000. Though the regional economies may have been affected by some common global factors such as U.S. economic cycles and information technology (IT) stock price movements, many of the recent, synchronized economic activities in the region can be attributed to strong macroeconomic interdependence.

Cross-country correlation analyses of major macroeconomic variables – such as real GDP growth rates, real private consumption, real fixed investment, and price inflation rates – over the last twenty years indicate that macroeconomic activities of the East Asian economies are generally highly correlated with each other, with the exception of China. Table 4 is a summary of factor loadings obtained from the first principal components of East Asian economies' variables.[4] The table indicates that Japan's real activity variables are more highly correlated with those of emerging East Asia than are U.S. activity variables. On the other hand, inflation rates of the United States and Japan are equally highly correlated with those of emerging East Asia. This suggests that the degree of emerging East Asia's real economic interdependence with Japan is greater than with the United States, while the degrees of its nominal interdependence with Japan and the United States are equally strong.[5]

[4] See Kawai and Motonishi (2004) for details.

[5] Earlier studies by Eichengreen and Bayoumi (1999) found that, in terms of supply shocks, some East Asian nations were just as closely connected with one another as European countries were. In terms of demand shocks, ASEAN countries were also well connected. More specifically, they found that two groups of economies in the region – one for Japan, Korea and Taiwan, and another for Hong Kong, Indonesia, Malaysia, Singapore and possibly Thailand – are natural groups of countries that are closely integrated. See also Bayoumi and Eichengreen (1994) and Bayoumi et al. (2000). Goto and Kawai (2001) also found rising macroeconomic interdependence in East Asia in the 1990s, in terms of movements of real output and shocks to real investment.

Table 4: Factor Loadings of the First Principal Components for East Asian Variables (1980–2002)

Countries	Real GDP	Real Con-sumption.	Real Invest-ment	Real Monet. Supply	Real Stock Price	GDP Deflator	CPI
U.S.A.	–0.11	–0.34	–0.41	–0.46	0.37	0.32	0.69
EU-15	0.04	0.17	–0.14	0.17	0.33	0.35	0.75
Australia	–0.21	–0.16	–0.21	–0.01	0.32	0.63	0.62
New Zealand	0.27	–0.04	0.20	–0.06	0.11	0.63	0.61
India	0.08	0.03	–0.04	–0.03	0.10	0.39	–0.02
Japan	0.58	0.39	0.41	0.15	0.72	0.26	0.56
Korea	0.85	0.78	0.67	0.01	0.89	0.26	0.42
China	0.05	–0.16	–0.27	–0.09	–	0.13	–0.01
Taiwan	0.44	0.26	0.27	0.07	0.71	0.08	0.49
Hong Kong	0.71	0.63	0.58	0.15	–	0.37	0.37
Singapore	0.72	0.75	0.60	0.29	–	0.20	0.60
Malaysia	0.87	0.87	0.95	–0.13	–	–0.38	0.27
Thailand	0.92	0.93	0.88	–0.02	–	0.10	0.28
Philippines	0.39	0.32	0.55	0.20	0.91	–0.12	0.39
Indonesia	0.90	0.63	0.89	–0.16	–	–0.25	–0.55

Notes: (a) The variables are defined in terms of log first differences.
(b) Principal components are obtained for each variable for the East Asian economies, including Japan, Korea, China, Taiwan, Hong Kong, Singapore, Malaysia, Thailand, Philippines, and Indonesia. But real GDP and GDP deflators include Brunei, Vietnam, Laos, and Myanmar; real consumption, real investment and CPI include Myanmar; and real money supply includes Laos and Myanmar.
(c) The figures are correlation coefficients between the first principal component for East Asia and the original, log first-differenced series of individual countries.
Source: Kawai and Motonishi (2004).

3. Impact of the Asian Financial Crisis

3.1 Causes and Lessons of the 1997–98 Crisis

There is now a consensus that the East Asian financial crisis of 1997–98 was triggered by massive reversals of capital flows and contagion. Though deeper, structural causes of crises vary, there was a common factor across countries: Imprudently managed domestic financial institutions over-extended loans to corporations that in turn invested the borrowed funds in unproductive projects. Furthermore, an initially benign-looking currency crisis evolved into a full-blown economic crisis due to the mutually reinforcing impacts of currency depreciation, financial sector deterioration, and corporate sector distress. Essentially the crisis was the result of interactions between the forces of financial globalization and domestic structural weaknesses (World Bank 1998, 2000).[6]

Forces of financial globalization. The crisis-affected countries had liberalized international capital flows and had been integrated with the international capital markets before the crisis. Many emerging East Asian economies clearly benefited from the liberalization and globalization of financial markets. From the mid-1980s to the mid-1990s, large inflows of capital, particularly long-term capital such as FDI, helped finance the region's rapid economic development and growth. In the several years leading up to the crisis, however, countries had received large inflows of capital in the financial and corporate sectors, particularly in the form of unhedged short-term capital due to relatively high domestic interest rates with *de facto* U.S. dollar-pegged exchange rates. As a result, the ratios of short-term external debt to foreign exchange reserves had risen to levels greater than one. The potential risk due to the "double mismatch" problem had become serious.[7] When market perceptions changed rapidly in 1997, these economies saw sudden outflows of capital and consequent large downward pressures on the currency. The currency crisis was triggered by the sudden reversal of capital flows, which is why the crisis is often called the "capital account crisis."[8]

Regional contagion of the crisis was spectacular. The Thai baht crisis spread to Malaysia, Indonesia, the Philippines and eventually South Korea within a few months, resulting in acute crises. At a later stage, Hong Kong was also affected, where the authorities managed successfully to contain its impact using unconventional policy measures.

Domestic structural weaknesses. The affected countries also had domestic structural weaknesses. Some foreign capital was intermediated by domestic financial institutions that over-extended loans to domestic sectors, including non-tradable real estate and construction; some found its way directly into domestic corporations. Over-investment in real estate and other assets contributed to the generation of asset bubbles, which left financial institutions with serious problems of non-performing loans when the bubble ultimately burst. In this way, financial institutions that intermediated foreign capital to domestic sectors were exposed to currency and maturity mismatches. Domestic corporations that were highly

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6 IMF (1998a, 1998b) and Summers (2000) emphasized the importance of domestic structural weaknesses, while Radelet and Sachs (1998, 2000) and Furman and Stiglitz (1998) emphasized the importance of fianncial globalization.

7 When an emering market economy borrows from abroad short-term, foreign-currency denominated bunds, it faces both maturity and currency mismatches – hence the "double mismatch" – because the borrowed funds tend to be invested at home with long-term maturites in domestic currency. As a result, the economy is exposed to both maturity risk (unanticipated rejection of roll-over of short-term liabilities) and currency risk (unanticipated currency depreciation).

8 See Yoshitomi and Shirai (2000); Kawai, Newfarmer and Schmukler (2003).

leveraged were also exposed to interest and exchange rate shocks. Inadequate regulatory and supervisory frameworks had left banks and corporations with imprudent financial management and, more generally, weak corporate governance. Steep exchange rate depreciation, high interest rates and tight budgets, induced by the eruption of a currency crisis in 1997, aggravated financial and corporate sector distress and led to a sharp contraction of overall economic activity in 1998.

Major lessons of the crisis. There are at least two major lessons from the crisis episode. First, policymakers in both developed and emerging market economies need to pay greater attention to managing the forces of financial globalization, particularly in a world of rapid short-term capital flows. Until the crisis, implications of the scope and magnitude of short-term capital flows were not fully understood by international investors, policymakers of the lending and borrowing countries, or international financial institutions. More fundamentally, there was a lack of concern over the volatile nature of capital flows and the need for monitoring and managing rapid capital flows. Management of financial globalization requires global frameworks that reduce capital flow volatility and enhance borrower countries' capacity to mitigate undesirable impacts of globalization, including macroeconomic and exchange rate policymaking.

Second, emerging market economies need to strengthen domestic economic systems, in particular their financial and corporate sectors. This task requires effective regulatory and supervisory frameworks for enhancing management and governance of financial institutions and corporations. Specifically, economies need to strengthen banks' asset-liability management capacity so as to avoid over-extension of loans and excessive currency and maturity mismatches; improve corporations' financial management capacity so as to maintain their sound financial discipline; and develop sound capital markets so as to provide alternative financing sources for corporations. If the domestic economic system becomes robust and resilient, a crisis could be prevented, or its impact on the economy would be mitigated even if a crisis occurs.

While not immediate causes of the crisis, declining productivity and relatively weak public sector governance are often identified as the fundamental weakness of pre-crisis East Asia. In fact, with high productivity and better governance, the negative impact of the currency crisis on the financial and real sectors of the economy would have been limited. There is indeed a case for reviving productivity and strengthening governance, because the rewards on them are high.

3.2 International Financial Architecture

Reflecting on these lessons, there was an increasing recognition that putting effective mechanisms in place to manage the forces of globalization and to strengthen the underpinnings of national economic systems was key to crisis prevention, management and resolution. Global efforts to reform the functioning of international financial markets and national efforts to strengthen country economic underpinnings have been made under the title of the "international financial architecture."[9]

Global efforts to reform the international financial system. At the global level, various reforms for crisis prevention, management and resolution have been proposed and some have been put in place. First, the IMF has introduced new lending facilities to meet the greater financial needs of member countries at times of crises or as preventive measures. The Supplemental Reserve Facility was established in December 1997 and has been used in South Korea, Brazil, Argentina and Turkey. It provides large financial assistance, without access limit, to members facing exceptional balance of payments difficulties resulting from a sudden and disruptive loss of market confidence. The Contingent Credit Line (CCL) was created in 1999 as a precautionary line of defense to help protect member countries in the event of an exceptional balance of payments need arising from the spread of financial crises, provided that the countries have pursued strong policies.

Second, the IMF has improved the transparency of its operations and policy deliberations. It has also decided to streamline its conditionality, particularly structural conditionality, in order to enhance ownership and effectiveness of its program.[10] The new approach is to formulate IMF programs on the presumption that structural conditionality shall be limited to a core set of essential features that are macro-relevant and in the IMF's core area of responsibility,[11] with a broader approach requiring justification based upon the specific country situation. Hence, IMF structural conditionality is expected to cover only those reforms that are relevant for a program's macroeconomic objectives. If those structural reforms that

[9] See Eichengreen (1999) and Kenen (2001) for discussions of reform of the international financial architecture.

[10] When the IMF intervened in crisis-affected countries in East Asia to contain the crisis, many viewed at last part of the IMF policies as not only inappropriate in some key areas but also exacerbating the severity of the crisis. A case in point is the initial Indonesian program (November, 1997), where the IMF insisted on the closure of 16 commercial banks without adequate protection of bank deposits, thereby exacerbating systemic bank runs (Sachs, 1998). In the January 1998 program, the IMF added a long list of structural reforms, specifying in minute detail such things as clove monopoly and selling plywood (Feldstein, 1998), which were largely irrelevant to the currency crisis. Misguided or excessively broad and detailed structural conditions undermined the country's "ownership" of the program and damaged its successful implementation. The IMF programs should have focused on the immediate need to stem capital outflows and restore currency market stability.

[11] The IMF's core areas of responsibility include: macroeconomic stabilization; monetary, fiscal and exchange rate policy, including the underlying institutional arrangements and closely related structural measures; and financial sector issues including the functioning of both domestic and international financial markets.

are critical for the achievement of the program's macroeconomic objectives are outside the IMF's core areas of responsibility, the IMF should seek assistance from relevant international organizations – such as the World Bank and regional development banks – to provide inputs in designing and monitoring the reform measures.

Third, private sector involvement (PSI) has been an important focus of reform. Given that the volume of private resources far exceeds that of official resources, private sector involvement is vital for crisis prevention and resolution. If official intervention were to bail out private investors without making them pay for their bad investment decisions, this would create a serious moral hazard problem. While private financial institutions decided to share the burden in helping crisis-affected countries in several cases, such as South Korea and Brazil, a definitive framework has yet to be developed. This is particularly the case for the restructuring of emerging economy bonds because of the large number and dispersion of bondholders involved.[12]

National efforts to strengthen domestic underpinnings. At the national level, developing economies have made efforts to step up "self-help" mechanisms for crisis prevention and management, such as the accumulation of adequate foreign exchange reserves, appropriately sequenced capital account liberalization, allowance of prudential regulations of capital inflows as financial safeguards, and upgrading of regulatory capacity to monitor capital flows and to impose official standstills if necessary. They also have made efforts to strengthen policy and institutional frameworks with an emphasis on macroeconomic management capacity and financial sector reform. Attention has focused particularly on the need to improve regulatory and supervisory frameworks in the financial system, to strengthen corporate governance, and to establish effective domestic insolvency procedures to deal with non-viable banks and corporations. The expectation is that

[12] The international community has begun to explore possible mechanisms for the debt restructuring of international sovereign bonds in the recognition that, at the time of a liquidity crisis, holders of sovereign bonds, along with other creditors, would need to contribute to the resolution of such crises. Two methods have been recommended: a contractual approach and a statutory approach. A contractual approach considers collective action clauses in sovereign bond contracts as a useful device for orderly resolution of crises; their explicit inclusion in bond documentation would provide a degree of predictability to the restructuring process. A statutory approach (Krueger, 2002) attempts to create the legal basis – through universal treaty rather than through a set of national laws in a limited number of jurisdictions – for establishing adequate incentives for debtors and creditors to agree upon a prompt, orderly and predictable restructuring of unsustainable debt. Similar approaches might be needed for private debt instruments as well, because of the surge in private-to-private capital flows – as was the case in East Asia.

with stronger domestic underpinnings in these areas, crises are less likely to occur and, even if they do, their impact on the economy tends to be limited.

One of the principal instruments for strengthening domestic policies and institutions is international best practice information in macroeconomic policymaking, financial sector regulation and supervision, and capital market infrastructure. Reports on the Observance of Standards and Codes (ROSCs), supported by various international organizations and agencies and adopted by the IMF in September 1999, cover 12 issues in three main areas. The macroeconomic policy area includes monetary and financial policy transparency, fiscal transparency, and special data dissemination standards in addition to the general data dissemination system. The financial sector regulation and supervision area includes banking supervision, securities regulation, insurance supervision, payments systems, and anti-money-laundering. The capital market infrastructure area includes corporate governance, accounting standards, auditing standards, and insolvency and creditor rights.[13] These processes are undoubtedly useful, but take time to be effectively implemented. And even if ROSCs are fully in place, crises may still occur.

3.3 Emergence of a New Regional Financial Architecture

While the international community and emerging market economies have focused on global and national policy reforms, a well-designed regional framework can also contribute to the stability of the international financial system for three reasons.[14] First, the global efforts are still inadequate and national efforts take more time to become effective. Though the global initiative has delivered certain results, they are far less than satisfactory – particularly in the areas of the IMF contingent credit line (CCL) and private sector involvement (PSI).[15] Second, as regional integration is deepening through trade, FDI and financial flows – as will be explained in more detail below – an effective framework for regional financial cooperation is essential to manage integration. Third, as economic contagion tends to begin with a

[13] The most prominent among these is the Financial Sector Assessment Program (FSAP) supported jointly by the IMF and the World Bank. The FSAP is intended to strengthen the monitoring and assessment of financial systems in view of the fact that financial sector weaknesses have played an important role in damaging a country's overall economic health.

[14] See also Bird and Rajan (2002).

[15] The CCL was virtually abolished in November 2003 because no country had been willing to use the facility due to the fear (a) that a CCL agreement with the IMF may send a wrong signal to the market that the country in question is in need of IMF financing, and (b) that possible cancellation of a CCL status can send a signal that the country's macroeconomc and financial conditions have deteriorated considrably, thereby triggering a crisis.

Table 5: Summary of Policy Lessons from the Asian Financial Crisis

Objective	**National Measures**	**Global Measures**	**Regional Measures**
	Improve mechanisms for crisis prevention, management and resolution at the national level.	***Improve mechanisms for crisis prevention, management and resolution at the global level.***	***Improve mechanisms for crisis prevention, management and resolution at the regional level.***
Preventing or reducing the risk of crises	***Avoid large current account deficits financed through short-term, unhedged capital inflows.***		
	• Secure adequate foreign exchange reserves • Maintain sound fiscal and monetary policy • Adopt a viable exchange rate regime • Establish orderly capital account liberalization	• Improve transparency and disclosure by IFIs • Strengthen IMF surveillance and policy advice • Remove regulatory biases to short-term and excessive international lending	• Strengthen regional policy dialogue and surveillance • Maintain intra-regional exchange rate stability • Develop a regional early warning system • Reduce “double mismatch”
	Aggressively regulate and supervise financial systems to ensure that financial institutions manage risks prudently.		
	• Strengthen regulatory and supervisory frameworks over financial institutions • Allow prudential regulation as financial safeguards and cushions • Improve information transparency • Introduce limited deposit insurance	• Tighten regulations over financial institutions that lend to highly leveraged institutions • Support implementation of international standards and codes	• Establish regional initiatives to improve regional regulatory and supervisory frameworks
	Erect an incentive structure for sound corporate finance to avoid high leverage and excessive reliance on foreign borrowing.		
	• Establish good corporate governance • Introduce greater competition to product, factor and financial markets • Develop capital market-based finance • Better information disclosure	• Identify best-practice corporate governance and its implementation tailored to specific country conditions	• Develop regional capital markets for mobilization of regional savings • Undertake regional initiatives for better corporate governance

Managing crises	***Mobilize timely external liquidity of sufficient magnitude.***		
	• Restore market confidence through coherent policy packages • Reduce moral hazard problems	• Strengthen IMF liquidity support, including CCL	• Establish a regional liquidity support facility to contain crises and contagion
	Adopt appropriate macro and structural policies to reflect the specific conditions and reality of the economy.		
	• Adopt appropriate monetary and fiscal policy contingent on the specific conditions of the economy	• Streamline IMF conditionality on macroeconomic and structural policies	• Strengthen regional capacity to formulate needed adjustment policies
	Bail-in private international investors.		
	• Impose official stand-stills • In extreme cases, allow involuntary private sector involvement (PSI)	• Establish international rules of the game through private sector involvement (PSI)	• Involve international creditors from outside the region
Resolving the systemic consequences of crises	***Move swiftly to establish resolution mechanisms for impaired assets and liabilities of banks and corporations.***		
	• Establish procedures for bank exits, recapitalization and rehabilitation • Establish legal procedures and formal frameworks for corporate insolvencies and workouts	• Establish international frameworks for PSI in external debt resolution • Strengthen capacity for official budgetary support	• Finance regional programs to help accelerate bank and corporate restructuring through regional MDBs and bilateral donors
	Cushion the effects of crises on low-income groups through social policies to ameliorate the inevitable social tensions.		
	• Strengthen social safety nets and to mitigate social consequences of crises	• Finance the activity through the World Bank and other international organizations	• Finance regional programs to help mitigate social impact through regional assistance

Source: Revision of table 8 in Kawai (2002a) and table 1 in Kawai, Newfarmer, and Schmukler (2003).

geographic focus, a regional framework for financial cooperation to address crisis prevention, management and resolution is a logical way to proceed.[16] From these perspectives, the regional economies have jointly embarked on initiatives to strengthen the regional financial architecture (see table 5).

[16] See Kawai, Newfarmer and Schmukler (2003).

Crisis prevention. Regional information sharing, policy dialogue, economic surveillance and monitoring are instrumental to crisis prevention at the regional level. The process should focus on both macroeconomic and structural issues, such as monetary and exchange rate policies (including domestic and foreign assets and liabilities of the central banks), fiscal positions and debt management, capital flows and external debts, financial system conditions, and corporate sector developments. Developing a reliable early warning system is useful in detecting macroeconomic, external and financial sector vulnerabilities. With effective surveillance mechanisms in place, each economy in the region is expected to be under peer pressure to pursue disciplined macroeconomic and structural policies that are conducive to stable external accounts and currencies. In addition, the regional economies need to ensure intra-regional exchange rate stability as well as reconstruct the banking sector and develop capital – particularly bond – markets to mobilize regional savings for regional investment, thereby reducing the "double mismatch" problem.

Crisis management. Once an economy is hit by a currency crisis, appropriate policy responses and timely provision of international liquidity are needed to prevent the economy from slipping into a serious economic contraction of systemic proportions. The pace of liquidity disbursement at the global level may be slow in times of crisis or contagion, because of cumbersome processes and disagreements over policy conditionality. To avoid long delays and to augment globally available resources, a regional financing facility can help close the gap. A financing facility that can rapidly mobilize a large amount of liquidity to head off a speculative attack is an obvious benefit if the attack is the result of irrational herd behavior. For such a financing facility to be effective, its provision must be accompanied by appropriate adjustment policy measures and, hence, the region must develop analytical capacity to formulate appropriate conditionality. This approach, however, must be consistent with, and complementary to, the global framework governed by the IMF, in order to exploit the synergy between the two, ensure policy consistency, and involve private creditors from outside the region.

Crisis resolution. To resolve a crisis, international efforts are needed to ensure that a crisis-affected economy returns to a sustainable growth path. In the face of a systemic crisis in the banking, corporate and social sectors, fiscal resource mobilization is essential for the quick resolution of the crisis. Fiscal resources that are needed to recapitalize weak banks, facilitate corporate debt restructuring and strengthen social safety nets may be limited by the lack of fiscal headroom or constraints to external financing on market terms. Fiscal resources are also needed for social sector protection.[17]

[17] A good example is the New Miyazawa Initiative of 1998, which supported the fiscal needs of crisis-affected countries in East Asia for restructuring and social spending.

4. Recent Initiatives for Regional Financial Cooperation

4.1 Early Attempts

ASEAN. In August 1977 the original five ASEAN central banks and monetary authorities – Indonesia, Malaysia, the Philippines, Singapore, and Thailand – signed the first memorandum of understanding on the ASA with the total facility of USD 100 million. In 1978, the total was increased to USD 200 million, with each member contributing USD 40 million. The objective was to provide immediate, short-term swap facilities to any member facing a temporary liquidity shortage or a balance of payments problem.

The ASEAN established a Surveillance Process in October 1998, with the objective of strengthening policy dialogue and policymaking capacity in monetary, fiscal and financial areas through information exchanges, peer reviews and recommendations for action at the regional and national levels. For this purpose, the ASEAN Surveillance Process has two components: a monitoring mechanism that allows early detection of any irregular movement in key economic and financial variables; and a peer review mechanism that induces appropriate policy responses to issues emerging from the monitoring exercise. The process is the first concrete attempt by a group of developing countries to establish mechanisms for regional policy dialogue.

Asian Monetary Fund (AMF) proposal. Following the success of the August 1997 meeting in Tokyo to agree on a much-needed financial support package for crisis-affected Thailand, Japan, with support from South Korea and the ASEAN countries that participated in the Thai package, proposed in September to establish an Asian Monetary Fund (AMF) to supplement IMF resources for crisis prevention and resolution. The United States and the IMF opposed this proposition on grounds of moral hazard and duplication. They argued that an East Asian country hit by a currency crisis would bypass the tough conditionality of the IMF and receive easy money from the AMF, thereby creating potential for moral hazard; and that an AMF would be redundant in the presence of an effective global crisis manager, the IMF. Without China's support, the idea had to be aborted.

In November 1997 the East Asian economies, together with the United States, Canada, Australia and New Zealand, agreed to establish the so-called "Manila Framework Group." Many, but not all, of the MFG member economies participated in the Thai financial package.[18] Its objective was to develop a concerted framework for Asia-Pacific financial cooperation in order to restore and enhance the prospects for financial stability in the region. Its initiatives included the establishment of a new mechanism for regional surveillance to complement IMF surveillance;

[18] These economies were called the "Friends of Thailand" – including Japan, Australia, China, Hong Kong, Malaysia, Singapore, Brunei, Indonesia and South Korea.

enhancement of economic and technical cooperation, particularly in strengthening domestic financial systems and regulatory capacities; strengthening the IMF's capacity to respond to financial crises; and development of a cooperative financing arrangement for the region to complement IMF resources.

New Miyazawa Initiative. Another example, which was highly successful, was the so-called "New Miyazawa Initiative" which contributed to the resolution of the Asian financial crisis. In October 1998, Japan pledged USD 30 billion to support the economic recovery of the crisis-affected countries. Half of the pledged amount was dedicated to short-term financial needs during the process of implementing economic restructuring and reform, while the rest was earmarked for medium- and long-term reforms. Part of short-term financial support was dedicated to currency swap arrangements with Korea (USD 5.0 billion) and Malaysia (USD 2.5 billion). The initiative provided major assistance for restructuring corporate debt, reforming financial sectors, strengthening social safety nets, generating employment, and addressing the credit crunch. A commitment to provide a large amount of resources helped stabilize the regional markets and economies, thereby facilitating the recovery process.

Asia Growth and Recovery Initiative. With the announcement of the New Miyazawa Initiative, the United States decided to take its own initiatives within a multilateral framework in order to assist the economic recovery of the crisis-affected countries. In November 1998, the U.S.A. and Japan jointly announced the Asia Growth and Recovery Initiative (AGRI), which was a multilateral effort to stimulate economic growth in Asia. With support from the World Bank and the Asian Development Bank (ADB), AGRI was intended to initially target the mobilization of USD 5 billion in bilateral and multilateral support to further corporate restructuring and restore market access to private capital, including for small and medium firms. Although it did not generate additional resources for East Asia's restructuring process nor yield visible results, it strengthened/established bond guarantee functions of the World Bank and the ADB.

4.2 Current States of Regional Financial Cooperation

Regional financial cooperation in East Asia has focused on three major initiatives:[19]

- Creation of a regional liquidity support arrangement through the Chiang Mai Initiative
- Establishment of surveillance mechanisms particularly through the ASEAN+3 Economic Review and Policy Dialogue process
- Development of Asian bond markets

[19] See Kawai (2002a) and Kuroda and Kawai (2002).

Liquidity support facility. The hallmark financing arrangement in East Asia is the Chiang Mai Initiative, which is designed to manage regional currency attacks, contagion and crises.[20] The Asian financial crisis highlighted the importance of establishing an effective financing facility so that the economies in the region can respond more effectively to the needs of their peers in a world of increased financial globalization. The finance ministers of ASEAN+3 who met in Chiang Mai in May 2000 agreed to establish a regional network of swap arrangements (BSAs) for its members, thus embarking on the so-called the Chiang Mai Initiative (CMI). The CMI comprised of two elements – the expansion of the existing ASEAN Swap Arrangement (ASA) in both amounts and membership and the creation of a new network of bilateral swap arrangements among ASEAN+3 members.[21] By the end of December 2003, sixteen BSAs had been concluded in line with the main principles, reaching a total of USD 36.5 billion excluding the commitments made under the New Miyazawa Initiative, and USD 44 billion including these commitments (see table 6).[22] This signified the conclusion of all conceivable BSAs at the time, and no further BSA negotiation is currently under way.

Members requesting liquidity support under the CMI can immediately obtain short-term financial assistance for the first 10% of the BSA facility. The remaining 90% is provided to the requesting member under an IMF program. Linking CMI liquidity support to IMF conditionality is designed to address the concern that balance of payments difficulties may be due to fundamental problems, rather than a mere panic and herd behavior by investors, and that the potential moral hazard problem could be non-negligible in the absence of an effective adjustment program.[23]

[20] There is another arrangement under the Manila Framework Group, that is, the MFG Cooperative Financing Arrangement, but this is intended to be only a second line of defence and is considered as ineffective.

[21] ASEAN Swap Arrangement (ASA), established among the original ASEAN-5 in August 1977 with a total facility of USD 100 million, expanded to a total of USD 200 million in 1978. Under the CMI, ASA membership was extended to include all ASEAN members, and its facility was further augmented to USD 1 billion.

[22] This is the sum of all BSAs, including the amount that Japan committed under the New Miyazawa Initiative – a total of USD 7.5 billion, or USD 5 billion with South Korea and USD 2.5 billion with Malaysia – , except that two-way BSAs are doubled for calculation purposes. Excluding the amount committed under the New Miyazawa Initiative, the total sum is USD 36.5 billion.

[23] Although up to 10% of the BSA drawings under the CMI can be provided for a limited period without an IMF program, subsequent additional disbursements have to be linked to an IMF program and, therefore, its conditionality.

Table 6: Progress on BSAs under the Chiang Mai Initiative (as of End-December 2003)

BSAs	Currencies	Conclusion Dates	Size
Japan-South Korea	USD-Won	July 4, 2001	USD 7.0 billion[a] (1-way)
Japan-Thailand	USD-Baht	July 30, 2001	USD 3.0 billion (1-way)
Japan-Philippines	USD-Peso	Aug. 27, 2001	USD 3.0 billion (1-way)
Japan-Malaysia	USD-Ringgit	Oct. 5, 2001	USD 3.5 billion[b] (1-way)
China-Thailand	USD-Baht	Dec. 6, 2001	USD 2.0 billion (1-way)
Japan-China	Yen-Renminbi	Mar. 28, 2002	USD 3.0 billion[c] (2-way)
China-South Korea	Renminbi-Won	June 24, 2002	USD 2.0 billion[c] (2-way)
South Korea-Thailand	USD-Won or USD-Baht	June 25, 2002	USD 1.0 billion (2-way)
South Korea-Malaysia	USD-Won or USD-Ringgit	July 26, 2002	USD 1.0 billion (2-way)
South Korea-Philippines	USD-Won or USD-Peso	Aug. 9, 2002	USD 1.0 billion (2-way)
China-Malaysia	USD-Ringgit	Oct. 9, 2002	USD 1.5 billion (1-way)
Japan-Indonesia	USD-Rupiah	Feb. 17, 2003	USD 3.0 billion (1-way)
China-Philippines	Renminbi-Peso	Aug. 29, 2003	USD 1.0 billion[c] (1-way)
Japan-Singapore	USD-Singapore dollar	Nov. 10, 2003	USD 1.0 billion (1-way)
South Korea-Indonesia	USD-Won or USD-Rupiah	Dec. 24, 2003	USD 1.0 billion (1-way)
China-Indonesia	USD-Rupiah	Dec. 30, 2003	USD 1.0 billion (2-way)

Notes: (a)The amount includes USD 5.0 billion committed (on June 17, 1999) under the New Miyazawa Initiative.
(b) The amount includes USD 2.5 billion committed (on August 18, 1999) under the New Miyazawa Initiative.
(c) The amounts are U.S. dollar equivalents.

Surveillance mechanism. Establishing mechanisms for frequent exchanges of views and consultations among regional-country financial officials is an obvious first step for meaningful financial cooperation. Information sharing and policy dialogue are essential to this process. Economic surveillance involves not only analyses of macroeconomic and financial conditions and policies of member countries but also identification of vulnerable aspects of the economy and finance as well as appropriate policy responses. This process requires frank and candid exchanges of views among other member economies, and will hopefully induce good policies through peer pressure.

Table 7: Regional Forums for Finance Ministries and Central Banks[(a)]

	Finance Ministries and/or Central Banks					Central Banks		
Groups Number Established	**ASEAN (10) 1967/8**	**ASEAN+3 (13) 1999/4**	**MFG[(b)] (14) 1997/11**	**APEC (21) 1994/3**	**ASEM[(c] (25) 1997/9**	**SEANZA (20) 1956**	**SEACEN (11) 1966/2**	**EMEAP (11) 1991/2**
Japan		○	○	○	○	○		○
China		○	○	○	○	○		○
Korea		○	○	○	○	○	○	○
Hong Kong			○	○		○		○
Taiwan				○			○	
Singapore	○	○	○	○	○	○	○	○
Brunei	○	○	○	○	○			
Cambodia	○	○						
Indonesia	○	○	○	○	○	○	○	○
Laos	○	○						
Malaysia	○	○	○	○	○	○	○	○
Myanmar	○	○					○	
Philippines	○	○	○	○	○	○	○	○
Thailand	○	○	○	○	○	○	○	○
Vietnam	○	○		○	○			
Mongolia						○	○	
Macao						○		
Papa New Guinea				○		○		
Australia, New Zealand			○	○		○		○
Nepal, Sri Lanka						○	○	
Bangladesh, India, Pakistan Iran						○		
USA, Canada			○	○				
Chile, Mexico, Peru				○				
Russia				○				
EU-15					○			

Notes: (a) APEC = Asia-Pacific Economic Cooperation; ASEAN = Association of Southeast Asian Nations; EMEAP = Executives Meeting of East Asia-Pacific Central Banks; MFG = Manila Framework Group; SEACEN = South East Asian Central Banks; SEANZA = South East Asia, New Zealand, Australia.
(b) MFG includes the International Monetary Fund, the World Bank, the Asian Development Bank and the Bank for International Settlements. (c) ASEM includes the European Commission.

Source: Kuroda and Kawai (2002).

There are several mechanisms for regional information sharing, policy dialogue, and economic surveillance (see table 7). The most important mechanism of all is the ASEAN+3 Process. Other major mechanisms include the ASEAN Surveillance

Process, the Manila Framework Group (MFG), EMEAP (Executives Meeting of East Asia-Pacific Central Banks), and trans-regional forums such as APEC and Asia-Europe Meeting (ASEM).

The purpose of the ASEAN+3 Economic Review and Policy Dialogue (ERPD) process, introduced in May 2000 by ASEAN+3 finance ministers, is to strengthen policy dialogue, coordination and collaboration on the financial, monetary and fiscal issues of common interest. Its major focus is on issues related to macroeconomic risk management, monitoring of regional capital flows, strengthening of the banking and financial systems, reform of the international financial architecture, and enhancement of self-help and support mechanisms in East Asia. Steps have been taken for cooperation in monitoring short-tem capital flows and developing a regional early warning system to assess regional financial vulnerabilities, with a view to preventing financial crises in the future. However, this process has not yet been as effective as it should be. There is no independent, professional organization that prepares comprehensive papers for:analyses, assessments and issues to support the process, except that the ADB provides some data on developing member economies.

Asian bond market development. Initiatives have been taken to develop Asian bond markets in view of the need to channel a vast pool of savings to long-term investment for growth and development within the region. This effort reflects the recognition that the financial system in East Asia has been too dependent on bank financing domestically and on foreign-currency financing externally and, hence, needs to be strengthened through the development of local capital – in particular bond – markets. By developing local-currency denominated bond markets, it is also hoped that the "double mismatch" problem of international capital flows – currency and maturity mismatches – will be reduced.

The EMEAP-led central bank process has established an Asian Bond Fund (ABF) to facilitate bond issuance. Its idea is to help expand the bond market through the purchase of bonds using foreign exchange reserves. So far, only U.S. dollar-denominated bonds have been purchased. To address the issue of the "double mismatch," Asian currency-denominated bonds must be purchased. The ASEAN+3 Finance Minister process has undertaken the Asian Bond Market Initiative (ABMI) to develop local currency denominated bonds. One of its aims is to establish a bond guarantee agency in the region and to promote bonds denominated in a basket of Asian currencies.

4.3 Logic of Regional Financial Cooperation in East Asia

There are several motivations behind the recent move to closer regional cooperation in the macroeconomic and financial area. While the most fundamental driving force is the deepening of economic interdependence in the region, some of them are defensive responses to the Asian financial crisis and others are more proactive:

- Deepening economic interdependence in East Asia through trade, investment and financial flows
- Hard lessons of the Asian financial crisis in 1997–98 resulted in the need to establish regional "self-help" mechanisms for effective prevention, management and resolution of regional financial crises as well as dissatisfaction with the existing global financial system governed by the IMF
- Regional financial stability as a basis for global financial stability
- Willingness to increase the Asian voice in global financial management

The most fundamental factor is the deepening of economic interdependence in East Asia. The region has seen not only real but also financial integration through market-driven trade, foreign direct investment, and financial flows. As a result, macroeconomic interdependence has become stronger. The deepening of macroeconomic and financial interdependence suggests a need for concerted efforts to internalize externalities and spillover effects, because macroeconomic/financial developments and policies of one country can easily affect other countries' performance and developments. It makes sense for such interdependent regional economies to institutionalize *de facto* integration through the establishment of regional cooperative frameworks, such as trade and investment agreements and macroeconomic and financial cooperation mechanisms. Given that one country's turbulence, shocks and crises could be easily transmitted to other economies within the same region, it is critical to establish financial safety nets. Cooperation among such economies would be easier because they are small in number – so the transactions cost for cooperation is small – and tend to face similar shocks and similar policy challenges.

As has been discussed earlier, the Asian financial crisis taught an important lesson, that is, there is a clear need for effective prevention, management and resolution of financial crises and contagion. The global initiative for the new international financial architecture has been less than satisfactory and the national efforts to strengthen national economic fundamentals take time to bear fruit. In addition, the East Asian economies have been dissatisfied with the way the IMF handled the crisis, particularly in Thailand and Indonesia. Hence, the general sentiment in East Asia has been that the regional economies must establish their own "self-help" mechanisms through systematic macroeconomic and financial cooperation for prevention and management of possible crises in the future. Such cooperation should include information exchange, policy dialogue, a regional liquidity support arrangement, and joint policymaking in certain critical areas – such as exchange rate policy coordination.

There are some proactive responses to the crisis. Since regional financial stability is a basis for global financial stability, effective regional financial cooperation is an obvious benefit not only for the regional economies but also for the global community. In this sense the East Asian regional financial architecture is consistent with, and even strengthens, the IMF's global role. At the same time, given the perceived imbalance and unfairness of the current distribution of IMF quotas, which is unrealistically skewed against East Asia, the regional economies have the desire to increase their voice in global financial management. Indeed they believe they can better achieve a greater voice by joining forces together.

4.4 Challenges for Further Institutionalization of Financial Integration

Next steps for closer financial cooperation. The ASEAN+3 countries have agreed to review the CMI starting in May 2004, including the amount, modality and IMF linkages. The total amount covered by the CMI may be increased, and its bilateral nature may be modified to become multilateral. If the degree of IMF linkages is to be reduced, effective surveillance would have to be put firmly in place. In addition to this review, the member countries may wish to consider further steps going beyond the CMI, which is essentially a short-term liquidity support mechanism. A medium-term financing arrangement that would be extended for two to three years – or longer – may need to be developed.

Another issue concerns surveillance and policy dialogue, that is, how to make the surveillance process effective, like the G-7 process and OECD processes (EPC, EDRC, WP3). Currently MFG serves better in terms of the quality of surveillance and frankness of policy dialogue than other processes in East Asia. A challenge is how to create a good surveillance culture within ASEAN+3. On Asian-currency denominated bond market development, incentives must be created to develop such markets on the part of both investors and issuers. In particular corporate governance for potential issuers needs to be enhanced, and well-designed national and regional market infrastructure needs to be developed – including disclosure requirements, accounting and auditing standards, rating agencies, bond default treatment, and depository and clearance systems.

So far no concrete attempt has been made to initiate exchange rate policy coordination. This presents a serious problem because intra-regional exchange rate stability is a public good for regional growth and economic stability.

Impediments to closer financial regionalism. There are four possible impediments to further financial cooperation at the regional level:

- East Asia's global orientation in finance – financial integration with the OECD countries and dependence on the U.S. dollar
- Concern about possible conflict with the global financial system governed by the IMF

- Diversity and heterogeneity in financial structure and capital account liberalization
- Hesitation of further coordination due to the fear of loss of national sovereignty

Some may argue that East Asia is more closely integrated financially with the OECD countries than with regional economies and that the region can gain more from further integration with the global market than with the regional economies in terms of risk sharing for smooth consumption. The East Asian economies are also still highly dependent on the U.S. dollar – for exchange rate stabilization, trade invoicing, external asset holding, foreign exchange reserve holding, and external liabilities. This dependence means that it will not be easy to reduce the role of the U.S. dollar and increase the use of Asian currencies for international transactions. The region's global orientation in finance leads to the view that the global financial system governed by the IMF could be more important than an alternative, regional financial system.

Diversity and heterogeneity within East Asia – in the areas of financial market development, scope and extent of exchange and capital controls, and institutional capacities – can constitute a serious impediment to regional financial cooperation. Diversity and heterogeneity imply that low-income countries – where financial infrastructure is insufficiently developed – will be slow in capital account liberalization and financial opening and, hence, it will be difficult to integrate themselves financially with the rest of East Asia at a fast pace. Given such diversity and heterogeneity, economies in the region have different policy objectives and priorities and desire to maintain national sovereignty over economic policies – fiscal, monetary, exchange rate, financial and structural. This preference for national policy independence would make it difficult to conduct serious economic and policy surveillance and to apply strong peer pressure for better policies. Closer economic policy coordination would be more difficult.

Assessments of the impediments. Some of these impediments are real, but they are not insurmountable either. It is true that financial integration tends to be global and the role of the U.S. dollar is still predominant in East Asia. However, the regional economies have found the need to manage financial globalization through various measures, including the strengthening of a regional financial architecture, which complements the global financial arrangement governed by the IMF. The region's governments have also found the cost of excessive reliance on the U.S. dollar very high so that they have embarked on measures to increase the use of regional currencies – such as the Asian bond market development.

Heterogeneity and diversity are not the ultimate impediment to regional financial cooperation, but political will is more crucial. For closer economic cooperation, a multi-track approach of strengthening cooperation among countries that have enough convergence would make sense. At the same time, the ASEAN+3 member economies, with assistance from Japan, Korea and multilateral development banks, must make every effort to guide low-income countries to upgrade their institutions and market infrastructure. With regard to the issue of economic sovereignty, the regional economies are increasingly realizing that their economies are highly interdependent so that closer economic policy cooperation is inevitable.[24]

5. Exchange Rate Arrangement in East Asia

5.1 Current Exchange Rate Arrangements

In this section, I identify the exchange rate arrangements that have prevailed in East Asia, particularly in crisis-affected countries and the neighboring emerging economies, before, during and after the 1997–98 currency crisis. As usual, it is useful first to take a look at the official exchange rate arrangements as published by the IMF. Table 8 summarizes changes in exchange rate arrangements in not only the crisis-affected countries – Indonesia, Korea, Malaysia, the Philippines, and Thailand – but also Japan, China, Hong Kong, Taiwan and other ASEAN countries.[25]

"Official" exchange rate arrangements. One can make several observations from the table. First, emerging East Asia has exhibited a variety of "official" exchange rate arrangements, ranging from a currency board system (Hong Kong and Brunei) to independently floating (Philippines). In between these two polar cases, there are conventional fixed pegs to a single currency (China and post-crisis Malaysia), a currency basket (Singapore and pre-crisis Thailand), and managed floating (pre-crisis Korea, Indonesia and Singapore). Second, three (Korea, Indonesia, and Thailand) out of the five crisis-affected countries saw a change in their official exchange rate arrangements in the direction of greater exchange rate flexibility, while Malaysia moved in the opposite direction after a brief period of rate flexibility. Hong Kong, Singapore, Taiwan and the Philippines have maintained largely identical exchange rate arrangements in the pre- and post-crisis periods.

It is now well understood that "official" exchange rate arrangements may not describe the accurate state and evolution of the exchange rate policies in emerging East Asia, particularly those in crisis-affected countries. Official arrangements do not indicate the precise degree of exchange rate fixity/flexibility, or the target anchor currency for exchange rate stabilization. It is thus important to examine the

[24] Stubbs (2002) takes the view that the ASEAN+3 will rise as a major regional and international player.
[25] For details see Kawai (2002).

actual behavior of the exchange rates, and empirically identify changes in such arrangements over time.

Table 8: Official Exchange Rate Arrangements in the East Asian Economies

Country	Article VIII (Date Accepted)	Pre-crisis and Mid-crisis Exchange Rate Arrangements (Year/Month of Change)	Post-crisis Exchange Rate Arrangement (December 2001)
Japan	01/04/1964	Independently floating (1982/07-present)	Independently floating
Korea	01/11/1988	Managed floating (1982/06-1997/11); Independently floating (1997/11-present)	Independently floating
China, P.R.	01/12/1996	Managed floating (1986/10-1998/09); Conventional fixed peg to the U.S. dollar (1999/01-present)	Conventional fixed peg to the U.S. dollar
Hong Kong	15/02/1961	Currency board arrangement with a peg to the U.S. dollar (1983/10-present)	Currency board arrangement with a peg to the U.S. dollar
Taiwan (a)	--	Managed floating (1989/04-present)	Managed floating
Indonesia	07/05/1988	Managed floating (1983/12-1997/07); Independently floating (1997/08-2001/09)	Managed floating with no pre-announced path for exchange rate (2001/09-present)
Malaysia	11/11/1968	Peg to other currency composite (1975/09-1993/06); Managed floating (1993/06-1998/09); Peg to the U.S. dollar (1998/09-present)	Conventional fixed peg to the U.S. dollar
Philippines	08/09/1995	Independently floating (1984/11-present)	Independently floating
Singapore	09/11/1968	Managed floating (1987/12-present)	Managed floating with no pre-announced path for exchange rate
Thailand	04/05/1990	Peg to other currency composite (1984/11-1997/06); Independently floating (1997/07-2001/09)	Managed floating with no pre-announced path for exchange rate (2001/09-present)
Brunei	10/10/1995	Currency board arrangement with a peg to the Singapore dollar (1996/03-present)	Currency board arrangement with a peg to the Singapore dollar
Cambodia	01/01/2002	Managed floating (1993/06-present))	Managed floating with no pre-announced path for exchange rate
Lao, P.D.R.	Article XIV	Managed floating (1989/03-1995/09); Independently floating (1995/09-1997/06); Managed floating (1997/06-present)	Managed floating with no pre-announced path for exchange rate
Myanmar	Article XIV	Peg to the SDR (1975/02-2001/12)	Managed floating with no pre-announced path for exchange rate (2001/12-present)
Vietnam	Article XIV	Peg to the U.S. dollar (1989/03-1990/03); Managed floating (1993/03-1998/09)	Pegged exchange rate within horizontal bands (1999/01-2001/12); Managed floating with no pre-announced path for exchange rate (2001/12-present)

Notes: (a) Information on Taiwan is based on Fisher (2001).

Source: International Monetry Fund, International Financial Statistics, various issues.

Adapted from: Kawai, Masahiro, "Exchange Rate Arrangements in East Asia: Lessons from the 1997-98 Currency Crisis". Monetary and Economic Studies (Special Edition, Bank of Japan), Volume 20, No. S-1, December 2002, p. 181.

"Observed" exchange rate arrangements. In examining actual data on exchange rate movements, I hypothesize that the roles of the U.S. dollar, the Japanese yen and the euro as anchors for exchange rate stabilization have changed since the outbreak of the East Asian currency crisis. A Frankel-Wei (1994, 1995) type of regression of daily movements in each economy's exchange rate on the movements of three major international currencies facilitates a convenient comparison of the roles of the G-3 currencies across East Asian emerging economies as well as over time. The regression equation is:

$$\Delta e^{j}_{t} = \alpha + \beta_1 \Delta e^{USD}_{t} + \beta_2 \Delta e^{JY}_{t} + \beta_3 \Delta e^{EURO}_{t} + u_t.$$

Here, Δe^{j}_{t} is the daily rate of change in the exchange rate of currency j in day t; α is a constant term; β_k (k = 1, 2,...) is the coefficient on the daily change in the exchange rate of currency k; and u_t is the residual term. The superscripts, USD, JY and EURO respectively refer to the U.S. dollar, the Japanese yen, and the euro – or the ECU before the introduction of the euro in January 1999. All exchange rates are expressed vis-à-vis the Swiss franc. The estimated coefficients are interpreted as the weights assigned to the corresponding currencies in exchange rate policies. The estimated standard error of regression residuals can be interpreted as a measure of exchange rate volatility. The regression results are summarized in table 9.

The table indicates that in the pre-crisis period, the U.S. dollar coefficients for many economies were close to unity with a reasonably large adjusted-R^2, suggesting a high degree of exchange rate stability vis-à-vis the U.S. dollar. In the mid-crisis period (July 1997 to December 1998), many affected economies in East Asia experienced noticeable declines in U.S. dollar weights and in the R^2-adjusted. The results for the post-crisis period (January 1999 to June 2002) indicate a greater diversity in exchange rate arrangements than in the pre-crisis period. A few countries have returned to the pre-crisis pattern of U.S. dollar-based exchange rate arrangement, while others have departed from the pre-crisis *de facto* U.S. dollar-peg to greater exchange rate flexibility.

What is noteworthy for the post-crisis arrangement is that a *de facto* currency basket system is adopted in Korea and Thailand (and Taiwan to some extent), in that both the U.S. dollar and the yen assume significant weights in the equation. The main reason for the *de facto* currency basket arrangement is that this would ensure better macroeconomic performance for Korea and Thailand. To the extent that fluctuations of the yen/U.S. dollar exchange rate affect these economies' activity, it would be in their interest to stabilize their exchange rates to a basket of the yen and the U.S. dollar – and possibly the euro – because this would reduce macroeconomic fluctuations.

Table 9: Regression Results of Daily Exchange Rate Movements for Major Emerging East Asian Economies: Pre-crisis, Mid-crisis, and Post-crisis Periods

(a) Hong Kong Dollar

Period	Const	USD	JY	EURO	R2-adj	D.W.	Std-res	No. obs.
90/01-91/06	-0.014	0.993 **	-0.001	0.007	0.9973	1.566	0.000425	389
91/07-92/12	-0.008	0.998 **	-0.011	0.006	0.9956	2.579	0.000597	394
93/01-94/06	-0.004	0.995 **	0.000	0.003	0.9975	2.147	0.000358	390
94/07-95/12	0.002	0.997 **	0.000	0.002	0.9994	2.018	0.000204	391
96/01-97/06	0.004	0.997 **	0.009 **	-0.007	0.9977	2.598	0.000277	391
97/07-98/12	0.000	1.001 **	0.006 *	0.000	0.9938	2.773	0.000528	393
99/01-00/06	0.016 **	0.993 **	0.001	0.003	0.9998	2.116	0.000087	390
00/07-01/12	0.000	1.004 **	0.000	-0.002	0.9999	2.054	0.000061	392
02/01-02/06	0.002	0.998 **	0.000	0.001	0.9999	2.124	0.000024	124

(b) Korean Won

Period	Const	USD	JY	EURO	R2-adj	D.W.	Std-res	No. obs.
90/01-91/06	0.172	1.004 **	-0.013	-0.011	0.9336	1.968	0.002149	389
91/07-92/12	0.210	1.026 **	-0.016	-0.006	0.8098	2.005	0.004458	394
93/01-94/06	0.045	1.014 **	-0.021 *	-0.002	0.9720	2.255	0.001208	390
94/07-95/12	-0.127	0.983 **	0.081 **	-0.045 *	0.9329	2.008	0.002205	391
96/01-97/06	0.354 **	0.960 **	0.065 **	0.020	0.8583	1.804	0.002378	391
97/07-98/12	0.758	1.149 **	0.039	0.084	0.0921	1.607	0.024301	393
99/01-00/06	-0.172	1.044 **	0.063 *	-0.036	0.7220	1.645	0.004023	390
00/07-01/12	0.256	0.982 **	0.284 **	-0.056	0.7550	2.107	0.004476	392
02/01-02/06	-0.510 *	0.654 *	0.175 **	0.101	0.7504	2.092	0.002783	124

(c) Singapore Dollar

Period	Const	USD	JY	EURO	R2-adj	D.W.	Std-res	No. obs.
90/01-91/06	-0.212	0.739 **	0.065 **	0.199 **	0.9167	2.309	0.002188	389
91/07-92/12	-0.140	0.758 **	0.077 **	0.185 **	0.9482	2.309	0.001857	394
93/01-94/06	-0.160	0.865 **	0.049 **	0.098 **	0.9199	2.131	0.001960	390
94/07-95/12	-0.189	0.789 **	0.098 **	0.117 **	0.9383	2.052	0.001915	391
96/01-97/06	-0.019	0.798 **	0.096 **	0.144 **	0.9294	2.167	0.001503	391
97/07-98/12	0.381	0.635 **	0.342 **	0.190 *	0.4851	2.181	0.006911	393
99/01-00/06	0.103	1.219 **	0.123 **	-0.194 **	0.8505	1.925	0.002547	390
00/07-01/12	0.035	0.948 **	0.197 **	-0.089 *	0.8975	1.942	0.002236	392
02/01-02/06	-0.170	0.610 **	0.223 **	0.064	0.8731	2.019	0.000346	124

(d) New Taiwan Dollar

Period	Const	USD	JY	EURO	R2-adj	D.W.	Std-res	No. obs.
90/01-91/06	0.040	0.840 **	-0.017	0.240 **	0.4605	2.849	0.008475	389
91/07-92/12	-0.154	0.967 **	0.033	-0.003	0.6336	2.913	0.006803	394
93/01-94/06	0.193	1.012 **	0.055	-0.019	0.6664	2.875	0.005199	390
94/07-95/12	0.023	0.948 **	0.060 *	0.028	0.8956	2.022	0.002807	391
96/01-97/06	0.024	0.946 **	0.036	-0.001	0.8264	2.734	0.002573	391
97/07-98/12	0.382	0.867 **	0.090 **	0.068	0.5698	1.702	0.005472	393
99/01-00/06	-0.131	0.999 **	-0.007	-0.012	0.8920	2.289	0.002128	390
00/07-01/12	0.322 **	1.019 **	0.000	-0.017	0.9030	1.799	0.002248	392
02/01-02/06	-0.200 #	0.990 **	0.109 **	-0.053	0.9320	2.475	0.001307	124

(e) Indonesian Rupiah

Period	Const	USD	JY	EURO	R2-adj	D.W.	Std-res	No. obs.
90/01-91/06	0.227	0.962 **	0.029	0.030	0.9094	2.084	0.002555	389
91/07-92/12	0.145 **	0.997 **	-0.006	0.016	0.9903	2.292	0.000900	394
93/01-94/06	0.131 *	0.995 **	0.010	-0.002	0.9739	2.044	0.001161	390
94/07-95/12	0.153 *	0.994 **	-0.015	0.011	0.9710	2.004	0.001438	391
96/01-97/06	0.156 *	1.009 **	0.001	0.002	0.9372	2.165	0.001528	391
97/07-98/12	2.982	0.512	0.692 *	-0.067	0.0167	1.961	0.053151	393
99/01-00/06	0.290	2.147 *	0.270 **	-0.643	0.1880	1.689	0.015509	390
00/07-01/12	0.354	1.423 **	0.140	-0.138	0.3370	1.719	0.012363	392
02/01-02/06	-1.410 *	0.289	0.012	0.300	0.2870	1.752	0.006755	124

(f) Malaysian Ringgit

Period	Const	USD	JY	EURO	R2-adj	D.W.	Std-res	No. obs.
90/01-91/06	0.072	0.892 **	0.027 **	0.096 **	0.9739	2.207	0.001279	389
91/07-92/12	-0.138	0.874 **	0.025	0.090 **	0.9487	2.006	0.001944	394
93/01-94/06	0.004	0.906 **	0.001	0.020	0.8170	1.507	0.003072	390
94/07-95/12	-0.062	0.869 **	0.059 **	0.084 **	0.9532	1.970	0.001738	391
96/01-97/06	-0.049	0.885 **	0.034 *	0.086 **	0.9226	2.018	0.001611	391
97/07-98/12	1.032	0.883 **	0.300 **	-0.035	0.1862	1.742	0.014911	393
99/01-00/06	0.000	1.043 **	0.000	-0.019 **	0.9980	2.943	0.000265	390
00/07-01/12	0.000	1.000 **	0.000	0.000 #	1.0000	3.040	0.000000	392
02/01-02/06	0.000	1.000 **	0.000	0.000	1.0000	2.919	0.000000	124

(g) Philippines Peso

Period	Const	USD	JY	EURO	R2-adj	D.W.	Std-res	No. obs.
90/01-91/06	0.571	1.054 **	0.043	-0.048	0.6891	2.011	0.005762	389
91/07-92/12	-0.363	1.048 **	-0.110	0.101	0.6700	1.991	0.006458	394
93/01-94/06	0.309	0.973 **	-0.006	-0.026	0.6154	2.013	0.005375	390
94/07-95/12	-0.045	0.986 **	0.062	-0.059	0.7805	2.221	0.004306	391
96/01-97/06	0.020	1.004 **	-0.005	-0.002	0.9936	2.202	0.000469	391
97/07-98/12	0.998	0.876 **	0.285 **	-0.022	0.1924	1.716	0.014420	393
99/01-00/06	0.268	1.410 **	0.085 **	-0.243 *	0.7190	1.968	0.006247	390
00/07-01/12	0.406	0.779 *	0.116	0.093	0.4460	2.067	0.008187	392
02/01-02/06	-0.150	0.628 *	0.031	0.150	0.7460	1.947	0.002744	124

(h) Thai Baht

Period	Const	USD	JY	EURO	R2-adj	D.W.	Std-res	No. obs.
90/01-91/06	0.014	0.961 **	0.031 *	0.023	0.9543	2.034	0.001766	389
91/07-92/12	-0.017	0.957 **	0.019	0.043 **	0.9782	2.007	0.001334	394
93/01-94/06	-0.037	0.972 **	0.012	0.006	0.9778	2.040	0.001049	390
94/07-95/12	0.017	0.877 **	0.069 **	0.049 **	0.9882	2.410	0.000848	391
96/01-97/06	-0.053	0.823 **	0.178 **	0.154	0.4746	1.978	0.006179	391
97/07-98/12	1.014	0.608 **	0.311 **	0.099	0.1046	1.877	0.017221	393
99/01-00/06	0.178	1.432 **	0.130 **	-0.297 *	0.6291	1.933	0.008783	390
00/07-01/12	0.189	0.971 **	0.197 **	-0.069	0.7902	1.980	0.003625	392
02/01-02/06	-0.310 *	0.697 **	0.176 **	0.070	0.9030	1.861	0.001558	124

(i) Chinese Renminbi

Period	Const	USD	JY	EURO	R2-adj	D.W.	Std-res	No. obs.
90/01-91/06	0.317	1.025 **	-0.036	0.007	0.7145	2.007	0.005179	389
91/07-92/12	0.211	1.037 **	-0.041	-0.032	0.8889	2.042	0.003212	394
93/01-94/06	1.037	0.969 **	0.082	0.064	0.1159	2.007	0.019926	390
94/07-95/12	-0.113 *	1.030 **	-0.001	-0.030 **	0.9829	2.082	0.001116	391
96/01-97/06	0.000	1.018 **	-0.010	-0.012	0.9335	2.832	0.001569	391
97/07-98/12	-0.008	0.996 **	0.001	-0.002	0.9919	2.471	0.000597	393
99/01-00/06	0.000	1.002 **	0.000	-0.001	0.9999	2.019	0.000033	390
00/07-01/12	0.000	0.998 **	0.000	0.001	1.0000	2.326	0.000043	392
02/01-02/06	0.000	1.001 **	-0.001 *	0.000	1.0000	2.121	0.000018	124

Note: Double asterisks (**) and a single asterisk (*) indicate that the estimated coefficients are statistically significant at the 1% and 5% levels, respectively.

Adapted from: Kawai (2002b).

5.2 Choice of Fixed, Flexible and Managed Exchange Rate Arrangements

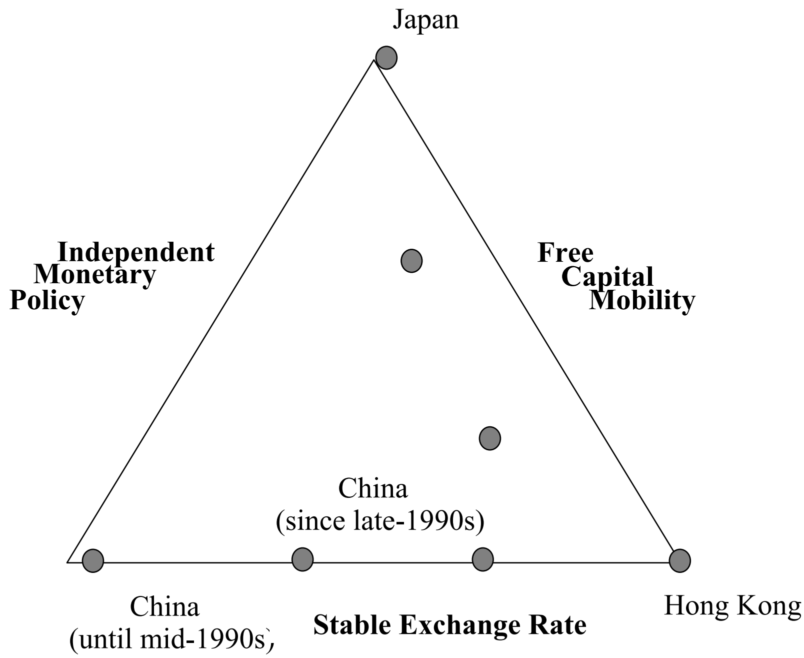
Two-corner solution approach? The "two-corner solution" approach suggests that developing economies should adopt either a free float – often supported by inflation or monetary aggregate targeting – or a hard peg – an institutionally committed fixed rate arrangement – in order to prevent a currency crisis (Eichengreen 1994, Obstfeld and Rogoff 1995, Fischer, 2001). The analysis above indicates that no emerging economy in East Asia willingly adopts freely floating exchange rates. The reason is because rates tend to be very volatile and can easily move beyond what the economic fundamentals dictate, exerting a harmful impact on trade, investment and growth. In economies like the United Sates, Japan or Western Europe, a free float would be less harmful because the financial markets are deeper and economic systems are more resilient. But developing economies have limited ability to absorb large exchange rate fluctuations due to the underdeveloped nature of markets for currency hedging. They are highly reluctant to adopt a free float due to the "fear of floating." For this reason, some degree of exchange rate stability appears desirable. On the other hand, no large or middlesized economy in East Asia adopts a hard peg – like a currency board system or unilateral dollarization. It may be appropriate for a small open economy like Hong Kong. In outward-oriented, mid-sized economies, maintaining international price competitiveness is critical to sustained economic growth. In economies that undergo substantial structural changes and productivity growth over an extended period of time, real exchange rates need to be adjusted for economic management. Forcing domestic prices and wages to change for such adjustment would be costly. Essentially, these economies need to have the option of allowing some degree of nominal exchange rate flexibility. Many emerging economies in East Asia appear to prefer intermediate, managed float arrangements, striking the right balance between flexibility and stability. While the "two-corner solution" approach gives exclusive attention to the objective of crisis prevention, East Asian emerging economies can pursue other legitimate objectives such as growth, trade and investment promotion through their use of exchange rate policy. A desirable option for them would be neither a pure float because of its potential for excessive volatility and misalignment nor a hard peg. A realistic approach would be what Goldstein (2002) calls "managed floating plus." This approach is a combination of a "managed float," i.e., a system with occasional intervention to limit excessive short-term fluctuations in exchange rates without being accompanied by a publicly announced exchange rate target, and a "plus," i.e., inflation targeting and aggressive measures to reduce currency mismatches. Given greater interdependence of the East Asian economies through trade and investment, stabilizing intra-regional exchange rates calls for closer coordination among the financial authorities in the region. One country's exchange rate adjustment can have serious, competitive implications for neighboring countries.Hence, the need for coordination on exchange rate policies. Another good reason for coordination is the fact that crisis contagion tends to be concentrated and economic spill-overs limited within a region.

Capital mobility and monetary policy regimes. In examining the choice of exchange rate regimes, three factors need to be taken into account:

- Desirability of exchange rate stability or flexibility
- State of capital account regulation or liberalization
- Need for independent monetary policy

The impossible trinity argument says that a country cannot achieve simultaneously exchange rate stability, free mobility of capital, and independent monetary policy (chart 5).

Chart 5: Exchange Rates, Capital Mobility and Monetary Policy: Impossible Trilemma



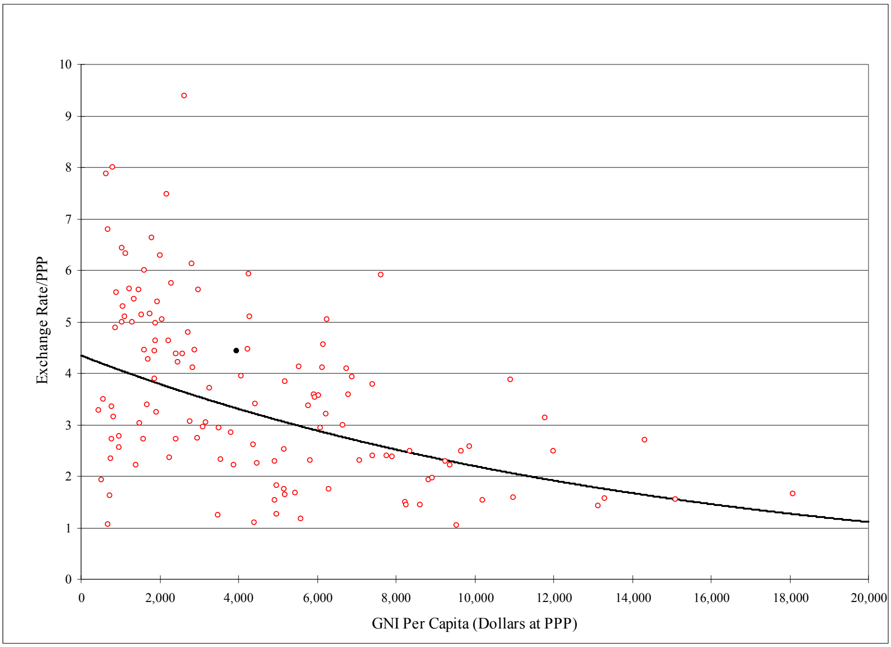
Note:
(a) Japan = Floating exchange rates, free capital mobility, and independent monetary policy
(b) Hong Kong = Fixed exchange rates, free capital mobility, and no independent monetary policy
(c) China (until mid-1990s) = Fixed exchange rates, no capital mobility, and independentmonetary policy
(d) China (since late-1990s) = Fixed exchange rates, limited capital mobility and partiallyindependent monetary policy

Desirability of exchange rate stability versus flexibility depends on various characteristics of the country in question: nature of shocks affecting the country; economic openness; the degree of monetary policy credibility; the depth and width of money markets; dependence on a certain, large country, etc. The state of the capital account openness has an important implication for the choice of exchange rate regimes. For financially open economies, like Japan, Hong Kong, the monetary authorities must make a balanced choice between exchange rate stability and independent monetary policymaking. Japan chooses to adopt a free float because of its desire to use an independent monetary policy – hence at the top of the triangle in chart 5. Hong Kong chooses to adopt a hard peg (a currency board system) because of its commitment to a fixed rate regime and the perceived ineffective of resorting to independent monetary policymaking in a small open economy context – hence the right-hand side corner of the triangle. For a financially closed country, like China before the mid-1990s, both fixed exchange rates and monetary policy independence can be retained – hence the left-hand side corner. As China relaxes its capital account regulation since the mid-1990s, its position has been shifting rightward in the chart. Many middle-income ASEAN countries, other than Malaysia, are adopting somewhere inside the triangle in the chart, given their less-than perfect financial integration.

China's Renminbi (RMB) issue. One of the important issues in East Asia is the future of the RMB – whether the currency should be revalued and if so how. As the deeper integration of China with the world, economy reduces effectiveness of capital controls and creates opportunities for leakages as has been observed in recent rises in errors and omissions in the balance of payments. In addition, the authorities will accelerate the pace of capital account liberalization, albeit gradually, over time to adjust to the economic reality – rising economic openness. This exposes China to larger and more frequent external shocks and may require exchange rate adjustment. In addition, the size of the Chinese economy will continue to grow, and for a large economy, a fixed exchange rate regime is costly and a flexible exchange rate regime is desirable – because it allows the authorities to pursue independent monetary policy – for effective macroeconomic management. Hence, China must exit from the current U.S. dollar peg regime sooner or later, particularly as capital account liberalization proceeds.

This exit pressure is mounting because the RMB appears undervalued. The pace of foreign exchange reserve accumulation clearly indicates that the RMB would be appreciating if the exchange rate regime was a flexible one rather than a *de facto* U.S. dollar peg regime. In addition, analysis of deviations from purchasing power parity (PPP) reveals that the RMB is undervalued, by some 25 to 30%, relative to the norm of developing countries. Chart 6 is a plot of the ratio of actual exchange rate relative to PPP (defined by the World Bank) in the vertical axis against gross national income (GNI) at PPP per capita in the horizontal axis for a group of middle- and low-income developing countries. The relationship is negative due to the Balassa-Samuelson effect. The negatively sloped line is a fitted line. China is above the fitted line and its deviation from the line for its income level is about 27%. As China is expected to grow in its per capita income, the degree of deviation from the fitted average will become bigger over time. In the current overheating context, revaluation of the RMB is highly desirable, because it will support the authorities' efforts to tighten the credit market.

Chart 6: Per Capita Income and Deviations from PPP for Developing Countries, 2001



Source: World Bank, World Bank Development Indicators (2003).

Even though RMB revaluation is needed, an abrupt shift to a floating regime is not desirable, nor is a large revaluation due to the shock to the economy. An exit from the current *de-facto* U.S. dollar peg with a moderate increase in rate flexibility is more appropriate to facilitate the needed adjustment and to increase the capacity to absorb various external shocks. More specifically, an exit to a "crawling wider-band" regime accompanied by a gradual revaluation (5–10% per year) in the next few years is recommended. The central rate should better be linked to a basket of major currencies, i.e., the U.S. dollar, yen, and the euro. A G3-currency basket system preserves both flexibility and stability, allowing the authorities to cope with large fluctuations of yen/U.S. dollar exchange rates, which are needed for China to accelerate economic transition and development. Exit must be made at a time of good fundamentals, not at a time of turbulence or crisis.

5.3 Exchange Rate Policy Coordination

East Asia is still at an infancy stage of policy coordination. The region's exchange rate policy coordination may evolve in three stages:

- Loose policy coordination: policy dialogue and economic surveillance coordination for institution building, and some limited joint action such as the joint adoption of a common G-3 currency basket system
- Tight policy coordination: macroeconomic policy coordination for regional exchange rate stabilization – an Asian "snake" or ERM
- Complete policy coordination – economic and monetary union with a single currency

Loose policy coordination: economic surveillance and a G-3 currency basket system. The regional economies can start policy dialogue on exchange rate issues as part of the enhanced surveillance process in order to reduce intra-regional currency volatility and misalignment and to facilitate international payments adjustment. This dialogue should focus on exchange market developments, capital flows, foreign exchange reserves, and monetary, fiscal policy and exchange rate policies. In the current context, the regional authorities may discuss such issues as a possible exit of the Chinese RMB from a U.S. dollar peg, the impact of possible RMB revaluation, and policies to facilitate smooth adjustments of the region's payments surpluses.

In addition, the emerging economies in East Asia may adopt a common G-3 currency basket system. For them, because of their increasingly interdependent nature, a certain degree of intra-regional exchange rate stability is clearly desirable, but it should not necessarily be based on the U.S. dollar. A reasonable choice of anchor for exchange rate stabilization would be a basket of G-3 currencies – the U.S. dollar, the euro and the Japanese yen. The reason is that with diverse economic relationships with the United States, Japan and the European Union, exchange rate stabilization vis-à-vis a well-balanced currency basket comprising the G-3 currencies would provide a better buffer to an economy's exposure to yen/dollar and yen/euro rate volatility. Actual currency weights in the new basket will depend on the relative importance of the major trading partners and FDI sources for the region; future expectations of trend movements of the yen/dollar exchange rate; the extent of international use of the euro in East Asia; and the success of internationalization of the yen. The degree of exchange rate stabilization depends on each economy's specific conditions and preferences. Adoption of a common currency basket among emerging East Asia – and loosely or tightly stabilizing each exchange rate to such a basket – would provide a benefit of maintaining relative stability of intra-regional exchange rates given the rising intra-regional economic interdependence in East Asia.[26]

A collective action problem. Even when a currency basket system is desirable, it is not easy for any single economy to move unilaterally away from the current, U.S. dollar-centered exchange rate arrangement to a new arrangement in which the relative weight of the dollar is smaller and that of the yen and euro larger. When neighboring countries stabilize their exchange rates primarily against the U.S. dollar, there may not be much incentive for any one country to unilaterally alter its exchange rate policy, which demonstrates a potential collective action problem associated with a move to a currency basket arrangement. Even though such a move can be Pareto improving, individual economies may lack the incentives to do so (Ogawa and Ito, 2000). Overcoming this "collective action" problem requires coordination among the countries concerned.

At least initially, coordination would simply require emerging economies in the region to simultaneously adopt a common currency basket as anchor. The operation of the regional currency basket arrangement requires less formality and has greater flexibility than the European Snake of the 1970s or the European Monetary System of 1979–98 because, as long as the basket does not include regional currencies, the need for a formal structure of policy coordination and surveillance is less compelling. This consideration is important given the current lack of commitment to full-fledged regional monetary cooperation in East Asia, the greater diversity in the level of economic and financial developments across countries, and the dynamic nature of East Asian economies, with rapid structural changes and possibly differing productivity growth and inflationary developments.[27]

Tight policy coordination: an East Asian "snake." As the region becomes more integrated, exhibiting greater economic and political convergence, and hence is better prepared for a more permanent commitment to economic policy coordination, more formal institutions capable of supporting such a commitment need to be built. Indeed, in the second stage of exchange rate policy coordination, several groups of countries in East Asia – like Japan and Korea, or Singapore, Malaysia and Thailand – that are close enough may initiate more aggressive, sub-regional currency stabilization. A multi-rack approach would be realistic because countries that are ready can go ahead for closer monetary and financial cooperation, and latecomers will gradually catch up with the forerunners.

[26] This benefit is particularly large for the ASEAN members, which completed the initial phase of the ASEAN Free Trade Agreement in early 2003 through tariff reductions on manufactured products to below 5 %. Preventing wide swings in exchange rates among the ASEAN countries would contribute to the maintenance of relatively stable international price competitiveness and the deepening of the free trade agreement.

[27] Economies with different rates of inflation and productivity growth can – and are expected to – make different adjustments to the reference rates with respect to the basket over the medium term.

For economies to be ready to participate in a regional scheme for exchange rate stabilization, they must strive for greater integration of markets for goods, services, money, capital and labor. They need to conclude their bilateral FTA/EPA as a first step, and then should make efforts to deepen the trade and investment relationship to create a customs union and eventually a common market. To make the task easier, East Asian FTAs should aim for common external tariffs, exclusion lists, rules of origin, and harmonization of standards, procedures and regulations. Convergence towards identical rules and common tariff rates, rules and standards is highly desirable.

To accelerate structural convergence, each economy must pursue structural reform to increase the flexibility of national economic systems (particularly labor markets), strengthen financial systems, standardize of rules of origin, regulatory policy, competition policy, etc. This is particularly the case with ASEAN: Its middle-income member states must reform their economies to cope with greater international competition, particularly vis-à-vis China, while its low-income members must pursue institutional and governance reforms to enable them to benefit from trade and FDI openness.

Finally, financial support mechanisms are needed to help sustain the "snake" through a short-term liquidity arrangement for frequent interventions in the currency market. In addition, systematic macroeconomic policy coordination is needed – particularly monetary and fiscal policy rules – to maintain the "snake" and make the stabilization system credible.

6. Concluding Remarks

This paper has argued that the emerging East Asian economies have achieved sustained economic growth through domestic structural reforms, external liberalization and market-driven integration with the global and regional markets. Though this process was temporarily interrupted by the Asian financial crisis in 1997–98, the economies have pursued further liberalization and reforms, deepened economic integration through trade, FDI and finance, and regained dynamic growth.

East Asia can make positive contribution to the stability of global finance and the currency system by ensuring regional financial stability, while preserving an open economic system. One promising approach to regional financial stability is to strengthen East Asia's emerging financial architecture in a way that complements the global financial architecture. This essentially involves the institutionalization of deepening financial integration and macroeconomic interdependence in East Asia.

There are several challenges for the region. First, the regional economies should accelerate institutionalization of real economic integration through regional and bilateral FTAs. Such regional trade agreements need to avoid the counterproductive "spaghetti bowl" effect and maintain WTO consistency. This requires conscious efforts to create trade facilitating environments for the region as a whole. The region needs to achieve a "WTO-plus."

Second, the regional economies need to make further progress on strengthening liquidity provision mechanisms and economic surveillance. It is crucial to enhance the functioning of the CMI on the occasion of its review that started in May 2004 through: the enlargement of its size by as much as ten times the current commitment; multilateralization and joint activation of the currency swap arrangements; and greater use of Asian currencies for swap arrangements. The IMF linkage can also be reduced, but only when accompanied by more effective economic surveillance: The region must address the earlier concern that an AMF that could lend too generously with too little conditionality might create a moral hazard for the government at the receiving end as well as for investors with stakes in the countries in question. It is therefore essential to develop an effective surveillance culture, improve the regional capacity to formulate appropriate adjustment policy in the event of a liquidity crisis and, to the extent necessary, enforce effective private sector involvement. Once these efforts are made, East Asia will have effectively established an Asian Monetary Fund that can contribute to regional financial stability without creating fears of moral hazard.

Third, it is time to initiate exchange rate policy coordination. The first step would be for the regional economies to discuss exchange rate issues as part of enhanced economic surveillance. The next step is the adoption of a common G-3 currency basket arrangement based on the Japanese yen, the U.S. dollar and the euro, given that emerging East Asian countries have diversified trade and investment relationships with the tripolar currency area countries and that the exchange rates among the major currencies would continue to be volatile. The following step would be to share a long-term vision for future economic integration in East Asia, including the possibility of forming an economic and monetary union with a single currency.[28]

Fourth, it is important to overcome various impediments to closer regional economic cooperation. Some of the impediments will become less serious as economic interdependence deepens in the region, while others require fundamental efforts such as integrating ASEAN late-comers with the regional and global markets. The region needs substantial structural reforms on the part of all economies, which is particularly the case with ASEAN: Its middle-income member states must reform their economies to cope with greater international competition, particularly vis-à-vis China, while its low-income members must pursue institutional and governance reforms to enable them to benefit from trade and FDI openness.

[28] Such a vision has been provided by East Asia Vision Group (2001) and East Asia Study Group (2002).

Finally, the IMF remains the only global financial institution governing the international monetary system and East Asia's regional financial architecture must complement its role. Strengthening the region's financial architecture will also strengthen the IMF's global role because regional financial stability contributes to the stability of global finance. At the same time, there is a need to rectify the imbalance and unfairness in the current distribution of IMF quotas and voting rights, which are heavily skewed against East Asia. The East Asian quotas are unrealistically small in relation to their actual weights in the world economy. Greater allocation of quotas to East Asia would undoubtedly make its representation at the IMF Executive Board commensurate with the changing reality and restore fairness and integrity in and for global financial management.

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Crises Prevention and Crises Resolution: The Roles of the IMF, Governments and Markets

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This conference is about 60 years of dialogue between past and future. On balance, the last sixty-year period has been truly remarkable. Eric Hobsbawm referred to the first half of it in his autobiography *Interesting Times. A 20th century life*: "In the thirty years after the Second World War, the world and what it was like to live in it changed more rapidly and more fundamentally than in any other period of comparable length in human history." He was referring just to the first half of the last 60-year-period, but the second half was no less impressive. Hobsbawm's observation may seem a bit vague for those who take for granted everything we have observed so far. Some may even consider the observation as displaced in a conference which is looking ahead. Of course, we should be forward looking. But the fact is that without recognizing how fast, deeply and irreversibly the world has changed from the 1940s to today, one will not be able to have a feeling for the possible future. Because the world has changed beyond recognition since the two Bretton Woods institutions have been created.

Just two examples to illustrate this point: when the Committee on Quotas decided on their allocation to the 44 initial members at the final conference in Bretton Woods, there were only four member countries in Africa: South Africa, Egypt, Liberia, and Ethiopia. Only three in Asia: China, India (still British India at that time) and the Philippines. Only two in the Middle East: Iran and Iraq. It was true that there were 19 in Latin America, but 14 of them, together, had roughly the same number of quotas as those assigned to the Czech Republic at that time. Today, just Africa, Asia and the Middle East have more than one hundred and ten fully fledged member countries in the Bretton Woods institutions.The second example is related not to the growing number of sovereign states' membership, but to demographic dynamics: it took thousands of years for humanity to come to 2.5 billion people (in 1950, coming from 1.6 billion in 1900) and only 50 years more for the world's population to reach the extraordinary number of six billion people!

The magnitude of the challenges involved was extraordinary and not only due to the huge needs for investment in basic social infrastructure. Expectations about fast improving living standards, higher income and consumption , on the part of hundreds of millions, rose exponentially as never ,ever before. At the same time, there has been economic growth; the level of technical knowledge is much higher, as is the understanding of the issues and the real or potential availability of resources. Therefore, one could well argue that, if complexity has increased, so has the ability to handle it. But the fact remains: expectations have also increased, and much faster.

This is one the reasons for the never-ending dialogue between past and future and for conferences like this one. Every generation revisits, rewrites and reinterprets the past in the light of two sets of factors: concerns about the burning issues of the present, and hopes, dreams, fears and expectations about the future.

Can history be of any guidance as we attempt to deal with the issues of crisis prevention and crisis resolution? The recurrent pattern of the many episodes of financial manias, panics and crashes observed over the last two centuries, indicates clearly that, unless human nature changes, there will be future crises. The question is how to make them less frequent, less deep and less disseminated. In other words, how to be more effective in terms of prevention and, once crises have erupted, how to have a quick and less costly resolution. This is the name of the game. The basis for which should be the view that the IMF and the markets must have complementary rather than antagonistic roles as the experience of successful cases of crisis prevention and crisis resolution has clearly suggested.

Experience seems to suggest that real life is far more daring than any effort of the imagination. History often surprises us with strange combinations and ever-shifting patterns The same sort of approach that Jeffrey Frankel followed in discussing exchange rate regimes: "there is no right exchange rate regime for all times and all countries or even for one single country at all times", could be applied more generally. Take, for instance, monetary regimes. A large and apparently growing number of countries adopt inflation targeting as a monetary regime. The regime is a very reasonable one, but it is doubtful whether inflation targeting could have been applied by all countries or even by a given country at all times.

The same reasoning applies to fiscal regimes. Countries differ in terms of the level and composition of their expenditures, the level and composition of their taxation, different phases of the cycle, some use structural measures or cyclically adjusted fiscal deficits, others not. So there is no right fiscal policy for all countries at all times. The same applies to growth strategies. There is no single way, no "one size fits all", not one unique path that all countries should follow. There is, admittedly, a huge diversity in this world .Countries do differ, in their history, economic structures, institutions, politics and cultural values. All of them subject to change.

This does not mean that anything goes, or everything is permissible. On the contrary: To state that there is no single fiscal, monetary and exchange rate regime, or a single growth strategy, does not imply that we have not learned a lot –

in many cases in a painful and hard way over the last few decades. For instance, regardless of the differences in terms of implementation, countries must have fiscal responsibility in the sense that they ought to be concerned with the inter-temporal solvency of their public sectors and in controlling debt to GDP ratios. They have to be concerned about the efficiency of government expenditure. They have to be concerned about the efficiency of the tax system in terms of the stimuli to investment, especially private investment. They have to be concerned about inflation control and monetary responsibility; having an exchange rate regime and trying to minimise excessive overshooting in either direction of the exchange rate. And they have to have sound institutions. Ultimately, the quality of governments and the quality of their interactions with the private sector depend, to a large extent, on the quality, the nature and the effective functioning of their institutions.

The observations above are relevant to the subject of crisis prevention. Barry Eichengreen highlighted the four elements usually underlying financial crises. Three of these elements are probably uncontroversial at the level of generality they are presented. The three of them are: first, countries should not have unsustainable macro-economic policies. Second, countries should not have fragile financial systems. And third, countries should correct institutional weaknesses, broadly defined. No trivial matters, those three, for real-life policy makers.

But there is a fourth issue, related to the international monetary financial and trading system. This system is global by its very nature, and requires actions which cannot be taken by individual countries in isolation. Here, supranational institutions and organisations come into play, and the essential role of the IMF has been increasingly recognized. However, for many years, up to a recent past, a relatively large number of developing countries considered themselves as passive victims of external events beyond their control, and blamed the outside world, and the external environment, as working against their advantage. As a reaction to this rhetorical position, the pendulum may have swung too far in the other direction. In fact, for many years, industrial countries used the "mind-your-own-business" type of counter-speeches: be concerned about your policies, improve your domestic situation, put your house in order and be less obsessive about the interactions that characterize the world economy.

Over the last 60 years, especially during the recent period, the understanding of the nature of these interactions has improved. Trade, finance, foreign direct investment and a host of other less tangible interactions are absolutely essential for most developing countries and their development efforts. Even when, as it is widely recognized, the truly fundamental development battles are fought, won, or lost ,in the domestic front.

Therefore, the best crisis prevention act comprises a set of policies that any developing country should take, and are related to moving forward in the three areas: sustainable macro-policies, sound financial systems (including their regulation and supervision) and strengthening institutions. But these are processes. Which take time, counted by generations, in the case of successful countries?

Nevertheless, it remains true that there are key issues which are international in nature, and must be internationally addressed. Trade, protectionism and subsidies to production and exports are as obvious as hard to handle. Not so obvious – and no less complex – are the issues related to international lending and international borrowing. It is important to discuss whether there was sufficient flexibility in the contracts under which capital was being internationally transferred in the late sixties/early seventies, given the contingencies that might have arisen.

Eaton and Gersovitz (1986) suggest that this topic subsumes important differences between lenders and direct investors. The fact is that the international indebtedness problem turned into a crisis largely as a consequence of an a priori asymmetrical allocation of risks between lenders and borrowers. And as we know, the late 1970s/early 1980s saw the very materialisation of these very high risks. The event suggested discussing whether contingency mechanisms of some sort, absent from earlier contracts, could emerge in the future to deal with this real or perceived asymmetry.

Richard Cooper, in a text published in 1979 (Dornbush and Frankel, 1979), showed a remarkable analytical acumen, writing before Volcker's dramatic interest rate increases and the second oil shock: "In many semi-industrialised countries and in a number of less developed countries there is a degree of financial precariousness that is much more widespread than at any time since at least 1950." What happened was that a number of countries took conscious and rational decisions to ride out the recession. They chose not to experience it in 1974 and 1975 but to borrow abroad instead and to maintain growth and domestic demand, and external debt rose accordingly. They took a more or less rational gamble, and that indeed was very healthy from the point of view of the world economy as a whole because they helped to limit the extent of the downturn. But it was a game they essentially lost. The recession was much sharper and longer than was anticipated at the time and now the countries made serious decisions as to how much to retrench and how to accomplish it."

This explains why a very large number of developing countries (and not only oil importers) faced serious debt problems in the early 1980s, beginning with Mexico in August 1982. It should be mentioned – and this has to do again with the patterns of cooperation between key governments, the Bretton Woods institutions and the markets – that it took more than seven years (from 1982, when the crisis erupted, to 1989) for the official sectors to recognize that there was no way out of the quandary other than having a scheme for debt reduction under an official umbrella.

This was the Brady Plan, which allowed countries individually to negotiate with their creditors, with a clear blessing of the official sector, a reduction either in the stock of debt or in debt service. The negotiations, such as the one with Brazil from 1991 to 1993, were long, difficult and painful, but the banks, as well as national officials, knew that there was a basic, internationally agreed official structure underlying their negotiation.

The case of Brazil is a good example of the issues involved. In the negotiations (1991–93), there were three important issues which still bear some relevance to the current discussion. First of all, the banks were very much insistent, from the very beginning, on a condition that there would be no deal unless a formal IMF agreement were in place before the time of the signing of the agreement. Brazilian national officials argued that the discussions were primarily between Brazil and the private creditors, and there was no point in bringing, to that forum, a Fund formal programme at that particular stage of the game. It was, for Brazil, a question of forum, form and timing, not of substance. But for the private sector, a formal IMF programme with Brazil, agreed early on, was a sine qua non condition.

The position of the creditors seemed to be rather strong. Larry Summers, who was Under-Secretary of the Treasury at the time, told the Brazilian negotiators , more than once, that under no circumstances the U.S. Treasury would make the "traditional" special issue of zero-coupon bonds, which was the basis for the collateral, unless there was a prior formal agreement with the Fund before the time of the signing.

When, during long and difficult negotiations, it became clear that a reasonable number of creditors banks were signaling an interest in reaching an agreement, Brazil proposed the introduction of a clause, similar to the collective action clause of more recent fame. In essence, the condition precedent for the deal remained a formal IMF agreement, unless a qualified majority of the creditors decided to waive the condition and to go ahead in the absence of such agreement. An important practical lesson about the relevance of voluntary, collective action clauses were learned when a qualified majority of the banks did vote for waiving the condition.

Secondly, since the Brazilians knew that a special issue of zero-coupon bonds was not going to be made by the U.S. Treasury, Brazil started earlier on, quietly and discretely to buy 30-year U.S. treasury bonds in the marketplace. Therefore, collateral was ready when it came to the signing. This was the second lesson from the Brazilian deal: one should not become totally paralysed because of a given government position.

Thirdly, an important rogue creditor decided not to go ahead with the deal, and requested an acceleration of payments under the old contracts. Brazil decided to go to court convinced that it had a very strong legal position and wide international official support .It is worth noting that at our request, the U.S. Treasury entered as "amicus curiae" with an affidavit in Brazil's favour, which proved important in our winning the legal fight in a New York Court against the rogue creditor.

All this shows that the interactions and the patterns of cooperation between the debtor country, the official sector(governments and multilaterals) and the private creditors is absolutely essential for successful strategies of crises prevention and crises resolution. This would always require consideration of specific circumstances.

The original proposal for an overall sovereign debt restructuring mechanism (SDRM),as put forward by the IMF would have been too far fetched ,because it would have required amending the Articles of Agreement and involving the IMF, which is already a lender and a policy advisor ,also as rating agency and as a judge, in setting up the terms and deciding if and when a given debt restructuring was required.

Therefore, many concerns have been raised about how these proposed procedures would affect the relationships between creditors and debtors, especially those debtors with a long-standing reasonably good relationship with the international financial community, intending to keep this relationship well into the future, and not willing to be seen or interpreted in other fashion. For this class of countries, collective action clauses are clearly a superior solution.

As is known, politics is less about facts and more about competing interpretations or versions about the facts. Consider for example what could have happened in Brazil, if the original SDRM had been in place and officially recommended for the country. The public sector external debt had a longer maturity and duration than the private sector's. It was relatively high, but well administered and sustainable, under reasonable assumptions. It had already been rescheduled in 1994. And, as rarely noticed, the public sector net external debt of Brazil (at SDRM discussion time) was already lower, in absolute dollar terms, than it was in the mid 1980's.

The level of private sector external debt was similar to the public sector. Private sector external debt in Brazil is the debt of relatively large domestic and international companies operating in Brazil, many of them exporters with a natural hedge against their foreign-denominated obligations. Of course, others do not, and one could always express concern about the transfer problem or conversion risks. However, it would be odd if the official sector would suggest that the Brazilian government should be involved in restructuring the external debt of large international and national corporations in Brazil. The public sector net external debt was not an insurmountable problem. And it should have been clear all along that the sovereign debt restructuring discussion should not have involved domestic public debt denominated and settled in national currency.

Another example which may illustrate my basic point about crisis prevention or resolution (and again with the Brazilian experience in mind), is the aftermath of our decision to float in early 1999. At first, this caused significant turmoil .But Brazil was fortunate in having strengthened up its financial sector, after it had defeated hyper-inflation in 1994. The government intervened in three of the seven largest banks in 1995, 1996 and in 1997. More than twenty (of the original thirty) state commercial banks were liquidated ,privatized or forbidden to operate with liabilities redeemable at par, a significant amount of private banks' mergers and acquisitions reduced the problem, and foreign ownership was allowed under certain conditions.

Hence, some of the problems of mismatches and balance sheet effects in banks and in corporations, that are common in countries with managed exchange rate regimes, were sharply reduced before the move to a floating exchange rate system.

But the fact was that in early 1999, Brazil was facing an enormous decline in the supply of short-term bank credit lines. The government opted for a cooperative undertaking, trying to convince the private financial sector of its commitment to sound economic policies. In early March 1999, meetings were held in New York, Toronto, London, Paris, Frankfurt, Madrid, Tokyo, Rome and Amsterdam. Prior to this, Brazil had formed a group of persons (informal bank coordinators) to help the government with the organization of the meetings. Brazil's objective was to get a firm commitment from the banks to a voluntary, but coordinated standstill in their lines of credit. The fact that the setting of the negotiations was one of the premises of the various national Central Banks, with the presence of their senior staff (and of Fund's staff) proved to be instrumental to gain the commitment of the banks to the standstill. In the end, there was no need to renew these agreements because lines were naturally expanded after the original six month agreement..

Once again, we demonstrated, in practice, that the Fund, the official sector and the markets should not displace each other. Quite on the contrary: The more confidence can be build, the more intensive the interactions, the better for the debtor, for the multilateral organisations and for the private sector. While the actual situations may not be ideal, they certainly would be worse if one of the parts refused to negotiate or to engage in good faith dialogue.

The Brazilian more recent experience could again serve as an example. In the run up to the October 2002 presidential elections, the real or perceived risks and uncertainties surrounding the possible future course of policies of a yet to be elected future administration, led to a dramatically deteriorating situation ,expressed in sovereign risk premia and exchange rate overshooting. The outgoing Administration negotiated a major IMF programme (roughly USD 30 billion, at least 80% of which to be available only in 2003); explained publicly and privately to all major candidates why it had done so, and tried to convince the private sector, domestic and international, that Brazil had become a more normal country.

In other words, that any future administration would be fiscally responsible, keep inflation under control, and respect contracts and international agreements. The smooth and civilized transition in late 2002 and the responsible macroeconomic policies which have been followed by the new administration in its first two years, have vindicated this view and backed the calculated risks taken by governments, by the IMF and, ultimately, by the markets.

In conclusion, there is no right scheme either for exchange rate regimes, monetary regimes, fiscal regimes, or growth strategies that could be used and applied all the times in all countries. Each case is different. The important thing is to understand past experience, develop an ability to assess current risks and uncertainties, have a feeling for the elements of continuity and change always present in any situation, and cultivate the art to become constructively engaged in addressing specific crises. The only thing that is sure, the only certainty we have as we move forward ,is that despite all strenuous efforts at crisis prevention, despite all lessons from the past, there will be crises in the future. And that they will have to be addressed. And that in doing so, neither governments, nor multilaterals, nor the markets can afford to ignore each other.

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Is there Consensus on the Crisis Prevention Toolkit?

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1. Introduction

It is a great privilege to participate in this conference on the occasion of the 60th anniversary of the Bretton Woods institutions. As with all anniversary occasions, this is a time to look back at history, which started with a conference in a mountain resort in New Hampshire in 1944. The mindset of the participants in that conference was determined by a specific global economic order and a particular set of policy priorities. The global economic order was basically a non-order. Following failed interwar attempts to re-establish a gold standard, there was no international monetary system in place, and the global economy was largely in shatters after several years of war. The policy priorities were derived from that global economic situation. They included rebuilding the post-war economies and avoiding a repeat of the disastrous protectionist and beggar-thy-neighbour policies of the 1930s.

It bears testimony to the political and intellectual capacity of the founding fathers of the Bretton Woods institutions that they have phrased their objectives in terms that remain largely valid at present. The opening Article of the International Monetary Fund's (IMF) and World Bank's Articles of Agreement highlight basically two main purposes: to foster economic and financial stability and to promote prosperity through economic growth. These purposes still capture well the central concerns of today's economic policy making. Also from the perspective of my intervention, which will focus on crisis prevention, stability and growth are key, as they offer the best insulation against potential financial crises.

What has changed in these six decades, however, is the environment in which the Bretton Woods institutions operate. The global economic and financial system has changed profoundly, as I would like to review briefly in the first part of my presentation. This changing economic environment has led to a fundamental rethinking about the best way to achieve the dual purposes of promoting stability and growth, and thereby of preventing financial crises. I will centre on this rethinking, and what it implies for the crisis prevention toolkit, during the second part of my presentation. Pre-empting on the conclusion of my speech, I do believe that there is a large consensus on the main elements of this toolkit. However, some elements of it remain subject to debate, and this is what I would like to focus on in the third part of the presentation.

2. Changes in the Global Economic System

Let me therefore start my presentation by reviewing four stylised facts of the evolution of the global economic system. Some of these facts have been highlighted by other speakers at this conference, so I can no doubt be very concise.

First, the initial Bretton Woods system of fixed exchange rates has been abandoned in the early-1970s in favour of a multitude range of exchange rate regimes. According to the classification recently proposed by Reinhart and Rogoff (2004)[1], presently only around one third of IMF member countries pursues an exchange rate peg. This fact may seem so well-known and obvious that you may wonder why it is worth recalling here. I believe its importance stems from the related debate on the link between the exchange rate regime choice and crises. Until a few years ago, there was a widely-held belief that a move towards corner solutions, under the form of either very hard pegs or free floats, would help insulate countries from financial crises. Possibly, the economic literature, which is heavily centred on speculative attack models, may have strengthened this view. However, recent experience has underlined that no currency regime is fully crisis-proof. For example, Brazil's financing problems did not go away with the adoption of a float in 1999. On the other side of the spectrum, the currency board of Argentina may have delayed, but has certainly not prevented a fully-blown crisis. I would therefore argue that prevention is clearly about more than the selection of an appropriate currency regime.

The second fact concerns the broadening IMF membership to virtually all countries around the globe. This broadening is more than a politically noteworthy fact. It has been accompanied by economic and financial integration of many new players. By way of illustration, over the last twenty-five years, a set of thirty-one emerging market countries has increased its share of global GDP from 26% to 35% (in purchasing power parity (PPP) terms) and its share of global exports from 17% to 24%.

The third fact relates to the growing role of financial markets. Sixty years ago, national capital markets were segmented trough capital controls. Since then, there has been a widespread process of capital account liberalisation coupled with a

[1] Reinhart and Rogoff (2004), "The Modern History of Exchange Rate Arrangements: A Reinterpretation", The Quarterly Journal of Economics, Vol. CXIX, Issue 1, 1-48.

growing integration of international financial markets. Official financial flows still dominated net external financing flows to emerging market economies during the 1980s. From the early-1990s onwards, they were largely outpaced by private flows. Therefore, the old governmental model used for crisis prevention, whereby international institutions advise national governments on the most appropriate actions, had to be re-thought. The role of the private sector has come to play a central role in crisis prevention efforts.

The fourth fact concerns the changing nature of financial crises. International financial integration has not only created better economic opportunities. It has also left individual economies more exposed to sudden stops or withdrawals of private funds. The second half of the 1990s and early 2000s have witnessed a series of crises characterised by problems in the financial account of the balance of payments. A few features of these capital account crises are worth recalling briefly. They have complex causes, related not just to unsustainable macroeconomic policies but also to balance sheet weaknesses or financial vulnerabilities. They are difficult to resolve, as their resolution requires the involvement of the private sector, for which tools are not yet fully in place. They tend to have disruptive economic consequences, as they are usually coupled with heavy output losses and high restructuring costs in the banking sector. They unfold with great speed, with decision times compressed to weeks or even days. And finally, they create huge financing needs, as can be seen from the unprecedented scale of official rescue packages. Needless to say that crisis prevention has to take into account this new pathology of crises.

3. Changes in the Prevention Toolkit

Throughout the sixty years of Bretton Woods, crisis prevention has remained a key responsibility of countries themselves. However, the role of the international official community in promoting good policies has gradually changed. I would argue that this change took place along three broad lines.

A first line relates to the growing role of private financial actors. In the initial Bretton-Woods approach, the promotion of sound policies was typically a closed-door official sector business. However, the increasing share of private finance has created a more prominent role for market discipline, whereby markets reward good policies through their lending and investment decisions. To make market discipline work, market participants should be able to carry out the best possible risk assessments. In part in response to that, the emphasis on the side of public policies has shifted towards enhanced transparency and the adoption of best practices. The IMF has started to disclose more information on its relations with member countries by publishing an increasing share of Article IV and programme reports. More than half of these reports, including for example those for the euro area, are currently being posted on the IMF website.

The IMF has also developed data dissemination standards, in response to the Asian crises which had revealed serious deficiencies in the availability of reliable statistics. Currently, 57 countries and economic areas – including the euro area – subscribe to the IMF's Special Data Dissemination Standard and 71 to the (less demanding) General Data Dissemination Standard. More broadly, the international community has promoted the adoption of standards and codes that have been developed over the years by a wide range of standard setters. Their implementation is being encouraged through the IMF and World Bank's Reports on the Observation of Standards and Codes (ROSCs). The ECB participated in this exercise with a report on transparency in monetary policy and payment system oversight and on the Committee on Payment and Settlement Systems' (CPSS) Core Principles for Systemically Important Payment Systems. Finally, ongoing work of emerging market issuers and private sector representatives on the Code of Conduct includes elements to enhance transparency and information-sharing in debtor-creditor relations as a means to avoid financial distress growing into a fully-fledged crisis.

The second line of change concerns the promotion of financial stability. In response to the growing importance of both domestic and international financial markets, the international community has enlarged its field of attention from macroeconomic policies to the area of financial policies. This trend is illustrated in developments at the IMF, which has created a International Capital Markets Department, launched a bi-annual Global Financial Stability Report, and developed – jointly with the World Bank – a dedicated tool, Financial Sector Assessment Programmes (FSAPs), to assess the strength of domestic financial systems. The creation of the Financial Stability Forum (FSF) and the current work on a new Basel Capital Accord, or Basel II, in which the ECB is heavily involved, constitute additional examples. Finally, also within Europe, there have been increased efforts to strengthen financial stability. For example, the EU has set up a new institutional structure of regulatory and supervisory committees, which is expected to play an important role in ensuring a more uniform and flexible EU regulation. Supervisory co-operation has also been strengthened by means of Memoranda of Understanding.

As a third change, let me mention the more intensive monitoring of balance sheet vulnerabilities. The existence of significant currency and maturity balance sheet mismatches in the run-up to the Asian crises has illustrated the importance of a thorough understanding of the structure and dynamics of public and private sector balance sheets. Fully-fledged and more forward-looking debt sustainability analyses, which should not shy away from running worst-case scenarios, have become an important tool of crisis prevention. Work has also intensified on early-warning systems, even though research has confirmed that such systems may be prone to wrong signalling and should therefore be used in conjunction with more fully-fledged economic analyses.

4. Three Open Issues

After reviewing such an impressive list of initiatives, one could be tempted to believe that the crisis prevention toolkit should be well-equipped to deal with future economic and financial shocks. I would argue, however, that a number of issues remain open. Let me highlight three of them.

First, views are still evolving on the appropriate balance between transparency and confidentiality. Until a few years ago, the policy dialogue between the IMF and its members took place in a context of full confidentiality. The increased transparency since the middle of the 1990s has, however, led to a double concern. First, policy discussions might become less frank and candid. Second, too much disclosure about vulnerabilities might actually precipitate crises. These considerations have shaped ongoing discussions on the publication policy of the IMF. Proposals for mandatory publication of IMF staff reports or mandatory participation in ROSCs or FSAPs have so far failed to find broad support. Likewise, information provision by emerging issuers to private creditors appears to be a contentious subject in the ongoing discussions on the Code of Conduct.

On these issues, I personally believe that it is indeed crucial to find a correct balance. In any policy discussion, there should be some space for confidential exchanges of views, which are not constrained by concerns about a possible negative impact on the markets. Yet, confidentiality of the policy dialogue between the IMF and its member countries should not be an excuse to conceal relevant factual information. There is some evidence that the identification of potential vulnerabilities in a confidential setting may not suffice to trigger corrective actions and that hiding critical information tends to delay the necessary adjustment process. Therefore, I believe further strides towards enhancing transparency should be welcomed.

A second open issue concerns intermediate instruments between IMF surveillance and lending. Under its traditional setup, the IMF functions on the basis of two modes: regular surveillance, based on Article IV reports, and lending, based on financial programmes. However, some observers have argued that, in a global economy with sudden stops and financial contagion, the mode of surveillance may fail to convince markets about the soundness of policies and may fail to provide sufficient financial insurance. In response, the official community has worked on or is working on a number of intermediate modes that are meant to strengthen IMF signalling and/or provide insurance. For example, the IMF established Contingent Credit Lines (CCL) in 1999 but abolished them in 2003, inter alia due to a lack of interest. Precautionary arrangements, which enjoy an increasing popularity among IMF member states, constitute another example. Finally, I could mention the recent proposal for a non-borrowing facility, launched at the recent G8 Summit in Sea Island.

In this debate, I think that, as a starting point, it is important to return as much as possible to the dual mode of the original Bretton-Woods setup. Suppose that surveillance were fully effective in strengthening policies. Suppose that financial programmes were always successful in restoring sustainability and market access. Under these assumptions, there would be no need for intermediate modes. However, as the surveillance and lending modes can probably never reach such ideal standards, I recognise that intermediate modes may have a role in the real world. However, they should be designed carefully. If they are used as a signalling device, there is a risk of potential adverse effects. Entry into an intermediate mode might be wrongly perceived as a sign of weakness and exit of strength. Incidentally, these signalling difficulties are in my view one of the major reasons for the failure of the CCL. If they are used as a financial insurance device, potential moral hazard on the side of debtor countries should be avoided. This can be done by applying strict conditionality and by respecting the normal limits for access to IMF resources.

My final open issue is a question. Have all these efforts helped to improve crisis resilience? Given that a large part of the prevention toolkit is at most a few years old, it is obviously too early to make a firm judgement. Nevertheless, I take some comfort from the fact that contagion has been relatively limited in recent crisis episodes (in particular that of Argentina in 2001). It is also reassuring that markets appear to better differentiate risks among individual countries. Admittedly, risk differentiation fell to uncomfortably low levels in 2003 in the context of the general "hunt for yield". But more recently, risk differentiation again increased, as illustrated by the widening of the estimated density function of emerging market sovereign spreads between March and May 2004.

5. Conclusions

To conclude, the crisis prevention toolkit has been enriched considerably over the last few years. As I have tried to illustrate, the various new elements of crisis prevention are not piecemeal responses or loose building blocks. They are logically intertwined elements of a new approach to crisis prevention, responding to the needs of the changing global economic system. This new approach is essentially a financial one, as it is based on the promotion of market discipline through enhanced transparency and best practices, the promotion of financial stability and the promotion of financially sound balance sheets.

The recent advances in crisis prevention are spectacular; fifteen years ago, probably no-one could have imagined that the IMF would be preparing country reports dedicated entirely to transparency and financial stability, that more than 100 countries would voluntarily subscribe to data dissemination standards, or that new fora such as the G-20 and the Financial Stability Forum (FSF) would be in place. This progress should provide us with some comfort that we are undoubtedly better equipped to prevent financial crises in the years to come. But let me end with a typical central banker's note of caution: as always, continued vigilance is important, and we have to be patient for another few years before we can firmly judge whether crisis resilience has really improved.

Crisis Resolution: What the IMF is Doing

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1. Introduction

It is a particular honor for me to be representing the International Monetary Fund (IMF) at a conference marking our sixtieth anniversary. It is 60 years ago since the delegates of the Bretton Woods conference assembled in New Hampshire.

It is clear from reading the papers of the time, that the key actors fully understood the weight of responsibility that lay on their shoulders. They were, after all, setting out to create a new global economic order; one which would focus on growth, stability and prosperity, and which would leave the Depression of the 1930s and the upheavals of war far behind.

They knew what they were doing. But I wonder if they envisaged how successful their ideas would turn out to be; and how durable. The framework they created has certainly stood the test of time, and has successfully weathered the occasional storm.

The world has changed, of course, far more, and in different ways, than anybody could have forecast in that New England summer. Remember, Bretton Woods took place a full year before the war ended. But the framework put in place then has survived largely intact. And so has the IMF's mission – to provide the stable international financial system that is essential to foster the expansion of trade and to promote economic growth that in turn raises living standards and reduces poverty.

Our mission is unchanged, but not our methods. The constantly evolving global economy has meant that from its early days the IMF had to be an institution accustomed to change. Our very success in achieving international financial stability enabled the resumption of private capital flows. But those flows in turn presented new challenges.

So we have always had to be adaptable. But the decade since our 50th anniversary turned out to be particularly challenging for us. A series of capital account crises in the 1990s tested the robustness of the international financial system to its limits.

That forced some pretty radical re-thinking about the best ways to prevent and resolve financial crises, both within and outside the IMF. Crisis prevention and resolution is at the heart of our work, of course. It is certainly the most visible aspect of what we do.

I want today to outline some of the changes we have made in order both to strengthen our work on crisis prevention and to make the resolution of crises more effective and less disruptive. In doing so I want also to emphasize that our work in this area encompasses much broader issues than many of us previously realized.

2. Crisis Prevention

I mentioned the rash of capital account crises in the 1990s. These came thick and fast. After Mexico came the Asian crises of 1997–98 – perhaps the point at which we came closest to a systemic crisis. Then there was Russia in 1998, Brazil in 1999, Turkey in 2000 and Argentina in 2001. These were all painful experiences for the citizens of the countries involved, and for those of us concerned to prevent each crisis from spreading.

Those years were an important learning experience for the IMF: even by our standards, we had to adjust rapidly to what was happening and in framing our response. We were not alone, of course – academic economists, too, were rapidly reviewing the conventional wisdom.

But look for a moment at the international financial system since 2001. We have had a global economic downturn – that is just the time when one would expect some countries to encounter difficulties, especially those most vulnerable to external shocks. Yet we have seen much less financial turmoil than we might reasonably have expected. It is arguable that the reforms already introduced, in the IMF and in many of our member countries, are beginning to bear fruit.

The best way of resolving financial crises, of course, is to prevent them from happening in the first place. The IMF puts a great deal of effort into this. We aim where possible to be pro-active: to encourage and assist our member governments to implement policies that will reduce the risk of crises and make their economies more resilient.

It is virtually impossible to judge how successful we are in this work, except by the absence of crises – and that will reflect a wide range of factors, not just the IMF's work. And, from the opposite perspective, we might always be right: but if our members did not accept our advice, there could still be crises.

We also seek to avert trouble when we see it looming. Even here, it is hard to isolate the IMF's role, when seeking to measure our success rate.

Trying to measure success is important: not because we want to take the credit but because we need to know whether what we do is effective. It helps us to judge how we detect when a crisis is imminent; and how to respond both to warning signals, if we spot them in time, and to crises when they do occur.

3. Pro-active Prevention

Thus, the biggest changes in the way we operate have been in what I called our pro-active work. For many years, the IMF has conducted surveillance of all member countries' economic policies, under Article IV of the Articles of Agreement. For most countries, this surveillance takes place every year, for some at slightly less frequent intervals. Staff analyze and assess economic policies, and aim to identify sources of potential weakness. In recent years, this work has been greatly strengthened and remains a central element of crisis prevention work.

Since this is, in some ways, an historical conference, perhaps I might be permitted an aside on this question of surveillance. Before the new Article IV was introduced in the 1970s, the major industrial economies were secretive about their economic policies, and especially so about their exchange rate policies. The IMF's official history of that period by Margaret Garritsen de Vries notes that before 1976, "the Fund found it awkward even to ascertain the exchange rate policies of many members."[1] Such was the atmosphere of secrecy and mistrust that even casual discussions between the Managing Director and Executive Directors "did not go well" – something of an understatement, I suspect.

Yet contrast that with the current IMF practice of publishing the reports of all Article IV consultations on our public website, unless a member government specifically objects to that; and only a very small number do object. Indeed, public endorsement of sound policies by the IMF is valued by members.

In fact, this public aspect of our surveillance work is more than a cosmetic device intended to pacify those who criticize us for being secretive. Publishing details of Article IV consultations can act as an incentive for the pursuit of sound economic policies: no government, whether from a large or a small country, relishes public criticism of any aspect of its economic policy.

But it is not just the manner in which we carry out our surveillance work that has changed. We have also broadened our criteria for assessing economic policies, as a direct result of what we have learned from the past and in particular what we have learned about the origins of crises.

4. Lessons Learned

Cast your minds back to the days of fixed exchange rates. The original Bretton Woods system of pegged rates served us well for many years, but it was not without its share of periodic crises. But the distinguishing feature of these crises was that they were current account crises. These were often caused by macroeconomic policies that were inconsistent with a fixed exchange rate, or by a

[1] Margaret Garritsen de Vries. 1985. The International Monetary Fund 1972–1978: Cooperation on Trial. Volume 2. Narrative and Analysis. Washington: IMF. p. 837.

marked deterioration in terms of trade against a backdrop of a restrictive trade regime and few foreign exchange reserves. Exchange controls prevented sizeable capital flows.

Private sector capital flows had largely dried up in the interwar period and capital flows during this first postwar era were largely official in nature: until the 1970s, capital account transactions remained heavily restricted. That changed with the ending of fixed rates which itself coincided with the oil price shock of 1973–74. By January 1974, the price of the benchmark Arabian light crude was 350% higher than it had been twelve months earlier. The oil producing countries were awash with cash that needed a home. “Oil revenues recycling” was born.

The period between 1973 and 1985 was characterized first by aggressive private bank lending to developing country governments, financed by deposits received from oil exporters; and then, from 1982, with the consequences of that aggressive lending, the problems of oil-importing developing countries unable to repay the debts they had taken on.

It was during this period that developing countries became the IMF's biggest customers: though it is perhaps worth noting *en passant* that even in 1960, when the IMF had only 68 members, two-thirds were developing countries (then known as less industrialized countries).

But in the developing country debt crisis of the early 1980s, IMF programs did not differ that much from what had gone before, except that there were now debt rollovers coordinated with private creditors, mainly the banks. Coordination was made easier because a relatively small number of banks held most of the sovereign debt.

By the 1990s, private flows had grown so rapidly that sovereign debt to the private sector, mostly bonds, greatly exceeded that to the official sector. In contrast with the 1980s, bondholders are far more numerous, are more scattered, and are more likely to have divergent interests. The crises of the 1990s were capital rather than current account crises, and it is this that has influenced our crisis prevention work.

Capital account crises have several distinguishing features:

- they can occur very rapidly, and can require a much more immediate response than current account crises;
- they occur because holders of a country's debt lose confidence in its ability to service that debt – this means that, in principle, a crisis can occur even if the country's macroeconomic policies are sound, if it is believed they will not be sustained, but when there are real doubts about macroeconomic policy, these can translate into a full-blown crisis very rapidly; and
- fixed exchange rates – we now know – tend to compound the problem – doubts about the sustainability of the exchange rate peg can precipitate a

crisis at least in part because it raises doubts about the ability to service debt.

The only effective policy response in such circumstances must include restoration of investors' belief that a country will be able fully to meet its debt service obligations. That, though, is easier said than done.

As I said earlier, prevention is far better – and easier – than cure. We now place much greater emphasis on the overall sustainability of government economic policies, when assessing a country's vulnerability. That judgment has, importantly, to include debt sustainability.

As I just implied, the IMF, in common with much academic opinion, has become markedly more skeptical about fixed exchange rates. It became clear during the 1990s that, with open capital accounts, countries can be extremely vulnerable to capital account crises if there is any doubt about the sustainability of the peg that, in turn, relates to the sustainability of debt servicing. Thus, with a fixed exchange rate there are two major sources of vulnerability: anticipation of exchange rate sustainability, or lack of it; and vulnerabilities arising because of balance-sheet mismatches between foreign-currency denominated liabilities and assets. Today, far fewer countries, especially among emerging market economies, are attempting to maintain fixed exchange rate regimes.

Sustainable economic policies must provide a stable macroeconomic framework. This is a prerequisite for the rapid growth that brings rising living standards and falling poverty rates. Macroeconomic stability is only achievable if there is firm control of the public finances, of course. But we also broadened the definition of what macroeconomic stability includes. Sustainable policies need efficient tax collection, and a well-functioning financial sector. But an effective judiciary, respect for property rights, contract enforcement and good governance are also important in creating a stable economic environment.

We now closely monitor the international capital markets as part of our surveillance work.

Our surveillance work aims to encourage the adoption of sound policies. But we also provide technical assistance to governments that have good intentions but lack the expertise necessary to put such policies firmly in place. This has grown increasingly important as we focus more and more on the quality and sustainability of fiscal and governance measures.

Of course, we also provide short-term balance of payments support in order to help meet financing gaps and so provide time for necessary policy adjustments. And when necessary we can provide financial support on a precautionary basis. Besides the conventional short-term assistance, we provide help on concessional terms for low income countries.

The support we provided Brazil in 2002 is a good example of the IMF's role in crisis prevention when one appears imminent and when underlying policies appear sound. In the middle of that year, Brazil was gearing up for its Presidential election in November. Its macro policies were sound.

But investors apparently doubted that these policies would be sustained by the successor government. The IMF support announced at the time of investor uncertainty during the pre-election period committed the new government to maintenance of the fiscal and monetary framework and thus reassured the financial markets. All three major presidential candidates committed themselves to maintaining sound policies, should they be elected.

Even before the election, after the IMF support was announced the spreads on Brazilian bonds had started to fall. So far, the Brazilian government has maintained its commitment to sound and sustainable policies and has stated its intention to continue doing so. Spreads fell further after the election and the central bank was able gradually to make significant reductions in interest rates. Economic growth has recently picked up and this should help the government remain committed to sound policies.

5. Crisis Resolution

The changes I have described in our approach to crisis prevention are substantial. We have greatly strengthened our surveillance work and made it more rigorous, including a greater emphasis on debt sustainability, financial sector health, and sound institutions and governance. And we have stepped up the provision of technical assistance, to help governments implement sound and sustainable policies. As a result of these changes we believe that the defenses against crises are much stronger than they were during the l990s. But I do not need to tell you that we live in a rapidly-changing world. Sustainable policies are those that bring the prospect of future stability and prosperity – and not those which appeared to hold such promise even in the recent past.

And there will always be crises. It is simply too expensive to have a failsafe system, to prevent every crisis. But though we can be sure there will be crises in the future, we can never be certain from which direction trouble will come.

We do try to spot potential sources of difficulty by making vulnerability assessments. Given what we now know about the causes of capital account crises, we try hard to assess where the main sources of weakness are. It's not foolproof, though.

Even if it were, of course, we would still have to confront the fact that governments do not always heed warnings – from us, or from the financial markets. They may find it politically difficult to adopt the measures that would reduce their vulnerability to shocks; or they may simply choose to postpone the necessary measures and so run the risk that they will leave it too late to prevent trouble. In cases where the IMF is not providing financial support, we ultimately have little influence beyond persuasion.

I outlined earlier what we had learned about the source and nature of crises from our experience in the 1990s. But it is important to remember that each crisis is unique. There may be similarities, but each situation will be different. Trouble might strike because of inadequate macroeconomic policies; or because of weaknesses in the domestic banking system; or because of an unsustainable debt burden. Few crises involve default, though, even if some kind of debt restructuring is needed. Ultimately each situation requires a different response.

6. Sovereign Debt Restructuring

Particular problems arise, of course, when a crisis is caused, or accompanied, by an unsustainable sovereign debt burden. There has been much debate in recent years about how the resolution of such crises could be improved and made more orderly. One of the difficulties in recent cases has been the challenge of coordinating the response of the private sector creditors when there are many more of them. There is always an incentive for one or more creditors to hold out in the hope of getting better terms than the rest.

This problem is not new, of course – a vigorous debate was under way as far back as the nineteenth century. But the rapid growth of private international capital flows in the 1990s lent new impetus to the search for a solution.

As you know, there has been much discussion of these issues in recent years, and several ideas have been floated, including that put forward by the IMF in 2001 for a Sovereign Debt Restructuring Mechanism (SDRM) and several proposals for the greater use of Collective Action Clauses (CACs) in sovereign bond issues. Essentially, these make it easier for debtors to negotiate with a large number of creditors by binding all creditors to the outcome of negotiations if a large enough proportion of creditors accept them.

In 2003, the International Monetary and Financial Committee (IMFC) strongly endorsed the use of CACs, calling for this to become the standard market practice. And this is what has happened. It soon became clear that the inclusion of CACs in bond issues carried no financial penalty, and they have become commonplace, much sooner than many people anticipated. It is, however, much too soon to evaluate the contribution such clauses can make to improving the orderly resolution of debt crises.

The IMFC also endorsed the idea of a voluntary code of conduct for debtors and creditors. The IMF is contributing to the work under way on this.

7. Looking to the Future

As I have outlined, the IMF has made considerable progress in work both to prevent crises and to deal with them when they do occur. I think we have shown both our willingness and our ability to learn from experience. We have done so in ways which some of our critics doubted. At the time, the Asian crisis was perceived in some quarters to have highlighted our shortcomings. Yet as I noted, a systemic crisis was avoided, and the Asian economies that had been affected recovered far more rapidly than anyone dared hope at the time the crisis struck. Indonesia was the last of the Asian crisis economies to complete its IMF-supported program; and it did so at the end of last year.

Complacency is dangerous, though, both for the IMF and for individual national governments. The absence of major crises at a time when one or more might have been expected does not mean we at the IMF can relax, any more than the global upturn means that governments can put off necessary economic reforms. Indeed, for governments, now is the ideal time to confront the economic problems they face, in order to make their economies more resilient to shocks. And for the IMF, any breathing space must be used wisely, to strengthen our crisis prevention work further.

There is always room for improvement, and indeed, we are likely to have a heavy agenda of reform in the next year or two. Our new Managing Director, Rodrigo de Rato, mentioned some of the issues on the table when he addressed a similar anniversary conference in Madrid this year. He noted, for instance, that the design of precautionary arrangements and contingent access to IMF credit are still on the agenda. The world economy is constantly evolving, and the IMF must continue to adapt to change and, where possible, try to stay ahead of the curve.

8. Conclusion

I started by commenting on how much has changed since 1944, and at the same time how little. The world is a very different place; and so is the IMF. Yet the principles agreed on at Bretton Woods have endured. A multilateral framework that fosters economic growth through the expansion of trade, underpinned by a stable financial system: that was what delivered the postwar surge in growth that brought so much benefit to so many people – and at a faster pace than ever before in history. And that is the framework that we still have, and those are the principles we in the IMF still seek to abide by.

And even though much has happened since even our 50th anniversary, I am struck by how much of what the then Managing Director, Michel Camdessus, said then still holds true. Let me quote:

> *"Few here would disagree that high-quality growth requires five ingredients: sound macroeconomic policies; structural policies that promote the efficient use of resources and a responsive supply side; an open trade and exchange regime; active and effective social policies; and good governance."*

But I think that the last word should go to one of the key figures at Bretton Woods. The then U.S. Treasury Secretary, Henry Morgenthau, was appointed Permanent President of the Conference. His words at the inaugural session powerfully remind us of the overarching aim of the founders – the aim that we all still share – and of why what we at the IMF try to so is of such great importance:

> *"Prosperity has no fixed limits. It is not a finite substance to be diminished by division. On the contrary, the more of it that other nations enjoy, the more each nation will have for itself....[And] prosperity, like peace is indivisible...Poverty, wherever it exists is menacing to us all and undermines the well-being of all of us."*

Our task is difficult – but it is surely worthwhile.

List of “Workshops – Proceedings of OeNB Workshops”

For further details on the following publications see *www.oenb.at*

		published
No. 1	The Transformation of the European Financial System “Where Do We Go – Where Should We Go?” *Vienna, 20 June 2003*	7/2004
No. 2	Current Issues of Economic Growth *Vienna, 5 March 2004*	7/2004
No. 3	60 Years of Bretton Woods – The Governance of the International Financial System – Looking Ahead *Vienna, 20 to 22June 2004*	12/2004

Periodical Publications
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For further details on the following publications see *www.oenb.at*

Statistiken – Daten & Analysen *quarterly*

This publication contains reports and analyses focusing on Austrian financial institutions, cross-border transactions and positions as well as financial flows. The contributions are in German, with executive summaries of the analyses in English. The statistical part covers tables and explanatory notes on a wide range of macroeconomic, financial and monetary indicators. The tables including additional information and data are also available on the OeNB's website in both German and English. This series also includes special issues on selected statistics topics that will be published at irregular intervals.

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Financial Stability Report *semiannual*

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Focus on European Economic Integration *semiannual*

Focus on European Economic Integration, the successor publication to the *Focus on Transition* (published up to issue 2/2003), contains a wide range of material on Central and Eastern European countries (CEECs), beginning with a topical economic analysis of selected CEECs. The main part of the publication comprises studies, on occasion several studies focusing on a special topic. The final section provides information about the OeNB's CEEC-related activities and conferences as well as a statistical annex.

Annual Report *annual*

The *Annual Report* of the OeNB provides a broad review of Austrian monetary policy, economic conditions, new developments on the financial markets in general and the financial market supervision in particular, the changing responsibilities of the OeNB and the role of the OeNB as an international partner in cooperation and dialogue. It also contains the financial statements of the OeNB.

Economics Conference (Conference Proceedings) *annual*

The *Economics Conference* hosted by the OeNB represents an important international platform for exchanging views on monetary and economic policy as well as financial market issues. It convenes central bank representatives, economic policy decision makers, financial market players, academics and researchers. The conference proceedings comprise all papers, most of them in English.

The Austrian Financial Markets *annual*

The publication *The Austrian Financial Markets* provides easy access to continuously updated information on the Austrian capital markets to the international investment community. The brochure is jointly edited by the OeNB and the Oesterreichische Kontrollbank AG (OeKB).

Proceedings of OeNB Workshops *recurrent*

The proceeding of *OeNB Workshops* were introduced in 2004 and typically comprise papers presented at OeNB workshops at which national and international experts, including economists, researchers, politicians and journalists, discuss monetary and economic policy issues. Workshop proceedings are available in English only.

Working Papers *recurrent*

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Conference on European Economic Integration
(Conference Proceedings) *annual*

(formerly East-West Conference)

This series, published by a renowned international publishing house, reflects presentations made at the OeNB's annual central banking conference on Central, Eastern and Southeastern European issues and the ongoing EU enlargement process.

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The English-language *Newsletter of the Economic Analysis and Research Section* is only published on the Internet and informs an international readership about selected findings, research topics and activities of the Economic Analysis and Research Section of the OeNB. This publication addresses colleagues from other central banks or international institutions, economic policy researchers, decision makers and anyone with an interest in macroeconomics. Furthermore, the *Newsletter* offers information on publications, studies or working papers as well as events (conferences, lectures and workshops).
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